

Section 1:

Introduction

At the beginning of transition many experts, based on the high level of industrial development, forecasted the rosy prosperity for Ukraine's economy. As soon as Ukraine has broken the records in hyperinflation and deepness of economic decline for the country not involved into the military conflict, the very same experts started to blame everyone for the obvious collapse of the economy. Among the culprits the following ones were named:

- Russia (for increase of the energy prices and the policy of discrimination for the Ukrainian goods);
- reformers (for poorly designed reforms);
- communist nomenklatura (for the opposition to these reforms); and finally
- the Western world – for the imposition of the economic and societal models allegedly alien to Ukraine, and for insufficient financial aid, etc.

The Ukrainian government was remarkably inert comparing to its Central European or even Russian colleagues. It reacted to the challenges in the case of emergency but hardly initiated the reforms by itself. While the government was hesitating with the market reforms that should allow an *invisible hand* to operate, the bureaucracy was pretty active in imposing the discretionary and discretionally enforced regulations, hence strengthening the *grabbing hand* of the *nomenklatura* and its allies. As a result, the reforms were gravely slow and inconsistent.

Meanwhile the majority of population were seeking hard the ways to survive, adapt and compete in the new, and not at all friendly, environment. Some of those people have chosen the way of independence and fair competition, often the hard work abroad, whereas other have taken the habitual way of paternalism and rent seeking. The former seemed to be numerous, but the latter seemed to be more powerful. While the former tried hard to adapt to the market competition, the latter distorted the emerging market in their own interests using the state as a tool. It is worth noting that both categories were united in the attitude to the state: the former hated it because it obstructed their free market activity by allowing the state capture by vested interests; the latter despised it for its docility and “undersupporting” of their activities. However, the admitted weakness of the state in transition by no means was a synonym to the weakness of the state bureaucracy in Ukraine. On the contrary, the state bureaucracy was and remains the main

player in the economy and politics. Typically, not the predatory businessmen exploit poor bureaucrats; rather the state officials use crony business to convert their administrative discretionary power into rents, although both have descended from the same nomenklatura, so one can hardly distinguish the leader and the follower in this predatory duet. They have to be regarded as just **two grabbing hands** of the same state captured by rent seeking nomenklatura.

The rent seeking was deeply inherited into the Soviet system based on the soft budget constraints and economy of favors. It did not shrink at the same rate as the sources of rent for the country dwindled. Initially, up to the 1994, Russian suppliers charged low prices for energy. But it did not benefit the Ukrainian economy as someone too naive could, perhaps, expect. The cheap Russian energy became a source of rent income for both the government officials and privileged firms with good connections to the government. It allowed for the postponement of reforms and, at the same time, diverted efforts of business away from the value creation. In 1994 this soft pricing was ceased. But the government did it worst for the economy by protecting Ukrainian energy intensive industries with soft crediting that was converted into the rapidly growing state foreign debt (hence, forced international crediting). Later on, barter deals and mutual offsets – the habitual ways of transactions under the “economy of favors” – were chosen for the price discrimination between privileged and non-privileged energy customers. Hence, the existing entities, whatever weak, were protected at the expense of more capable ones by the means of “virtual economy”. As a result, due to the institutional reasons the highly vulnerable energy intensive sector was not merely preserved, but was expanded making Ukraine even more dependent from the Big Brother. At the same time, the government has found yet another, quite unusual, source of a short-term rent. Ukraine followed Russia’s bad example in financing the budget deficit (caused by the economic inefficiency and unwillingness to eliminate soft budget constraints) with Ponzi-like T-bills game in 1996-1998 (August).¹ And the traditional way of rent seeking through the fiscal (export and import rents, subsidies, etc.) and monetary (currency devaluation) channels surely remained notable for all the observed period.

Lack of necessary reforms and crowding out of a value creating activity were the obvious outcomes of such policies. During all transition period the structure of the economy, and, particularly, of exports, has been worsening. The share of raw materials (the production of which was doubtfully value

¹ Of course, such a borrowing is not a source of rent in its traditional definition, but under certain circumstances can be regarded similarly. The fact that the cash flows from the T-bills market were accounted as the budget revenues (with no distinction to the tax ones) can be regarded as an indirect evidence for that. We consider this issue in Section 3.

adding) tended to increase over time, while the high-effort manufacturing contracted. Paradoxically, the heavily subsidized energy intensive bulk commodities played the same role as the exportable raw materials do in the traditional models of Dutch disease. In addition, T-bills with incredible discounts served as a sort of bestseller export commodity. To complete the striking similarity with Dutch disease, after a rapid disinflation the real exchange rate started to appreciate, so Ukrainian final goods became noncompetitive even domestically. But instead of exhausting the natural resources, the “trust resource” – a blank credit history of the newly independent country – was used by the ruling circles. This peculiar game should clearly have been ended sooner or later, and for Ukraine the X-day could be expected to come in November 1998.

In fact, the crisis came two months earlier. Ukraine was bypassed by Russia that announced a default in August, allowing Ukraine to make the “soft” restructuring of her debt and escape the sound default. So, Ukraine has in fact benefited from the Russian default *per se*, although she has been affected by other consequences of the world financial crisis, mostly by the fall in the energy prices and 4-fold depreciation of the ruble. Paradoxically, for the energy scarce Ukraine, the effect of increasing world oil prices was not severe due to semi-fixed prices charged by Russian monopolies toward their Ukrainian customers, which made the production costs of the latter relatively stable although still quite high; and the capacity (demand for Ukrainian goods) of the Russian market that was positively correlated with oil prices. However, the main cause of a sharp economic decline in the fall of 1998 was not the collapse of the Russian market, as for other CIS countries, but (1) the leap in competitiveness of the Russian ferrous metal and chemical exporters which outperformed their Ukrainian competitors due to the depreciated ruble and cheap energy, and (2) the severe restrictions at the currency market that were in place for too long.

Meanwhile, in a few months, right after these restrictions were abandoned, economy has started to grow at a strikingly high rate. Is this the long-awaited sustainable growth, driven by the revelation of the great human potential – in 1997 Ukraine was rated as #2 in the world by the number of patents/GDP ratio (Table 1)? Or just a temporary boom driven by the boost in, the very volatile, world demand for the secondary raw materials – metal, mineral and chemistry products that constitute 66.2 percent of Ukraine’s exports? What indeed prevents Ukraine from the disclosure of its human and productive potential – is it primarily market or the government failure? And by what extent this potential does exist indeed? Which institutional factors have determined the observed way of development? Why the Ukrainian elite resisted reforms so badly instead of finding new ways to the competitive market economy and seeking political support from the population? Which policy is needed for achieving sustainable economic growth in Ukraine?

And, last but not least, is the government able to conduct the appropriate policies?

This book seeks answers to these questions. We analyze the reasons for Ukraine's embarrassing economic performance over most of the last decade; provide explanations for a long-awaited recent economic recovery, and contemplate about the future economic prospects.

The remainder of the book is organized as follows. Section 2 concentrates on such major determinants of economic growth in transition as initial conditions, macroeconomic policy, structural reforms, and institutional environment. What is the contribution of the above factors to explaining Ukraine's economic performance over the last decade? To what extent and why the transition experience of Ukraine is different from that of Russia, Latin America and other countries undergoing economic transformation? This section of the book provides some answers to these questions and serves as the basis for a deeper analysis of the Ukraine's transition experience that follows later in the book.

Section 3 identifies the main problems hindering economic performance of Ukraine.

Subsection 3.1 analyzes the institutional and behavioral problems, comprising of the elite's non-preparedness to conduct structural reforms and their inherited from the Soviet times overconfidence in the vast natural resources. As natural resources in a broader sense we may consider human capital, unlimited patience of population and its ability for readjustment in times of hardship. The partial and asymmetric institutional reform resulted in a highly distorted economic structure, dominated by the old Soviet-era enterprises. The elite lacked the capacity and willingness to promote initiation and expansion of the new competitive businesses.

Subsection 3.2 describes overindustrialization, the curse of the Ukrainian economy. Industrial lobby supported employment and the volume of output at the high social cost. This inhibited market exit of loss-makers.

Section 3.3 focuses on the rent-seeking activity, which has a re-distribution nature, in the energy and energy intensive industries with the government as a major instrument of rent seeking. This is Ukraine's specific feature, which hardly can be found elsewhere. At the same time, unlike Russia, Turkmenistan and Azerbaijan, Ukraine lacked the easy sources (export of energy resources) of income, which could partially compensate the social costs associated with transition. We also consider among rents the wasted domestic and external borrowing, which was actually spent on withholding of structural changes, first of all, bankruptcies of large insolvent enterprises. These enterprises are treated more favorably than the other economic agents.

Subsection 3.4 examines the factors that contributed to the creation of the unfriendly business environment. It analyzes numerous barriers for local and foreign entrepreneurs to do business in Ukraine.

Section 4 presents empirical facts on and evidences of the patterns of Ukraine's transition. After restoring independence in order to pacify bureaucracy and gain enormous rents the authorities preferred to maintain the status-quo, which led to the preservation of old inefficient Soviet-style bureaucratic machine slightly colored by new rhetoric and renaming. Creation of new institutions and business culture was hindered by an extensive administrative intervention and excessive and unstable regulation. Another confirmation of the government failure is poor contract and law enforcement, and absence of real bankruptcy, although the number of law enforcement employees and expenditures on their activity has increased. The government failure to carry out transformations effectively and at a rapid rate resulted in flourishing ugly forms of transition such as soft budget constraints and non-monetary means of payments. The behavior of the most flexible resource – the labor force - in times of transition is also analyzed here.

Section 5 considers the effects of the Asian and, especially, of the Russian financial crises as a turning point for depletion of the short-term rents and creation of stimulus for conducting the real changes in the economy. It analyzes the recent economic recovery in Ukraine.

Section 6 is devoted to the assessment of the potential for the creation of the new institutional environment and medium-term growth. We consider three scenarios: pessimistic, baseline, and the optimistic one. This section is not a macroeconomic forecast but rather an evaluation of the comparative advantages of Ukraine, first and foremost, of her human capital, depending on the rate of elimination of the political impediments for growth.

Section 7 summarizes main findings and suggests directions for future research.

**Overview of the main features of the
Ukrainian transition experience in
comparison with "new" transition countries
(Central Europe and Russia) and "old"
transition countries (Latin America)**

A literature on the determinants of economic growth in transition generally concentrates on such major factors as initial conditions, macroeconomic policy, structural reforms, and institutional environment. What is the contribution of the above factors to explaining Ukraine's economic performance over the last decade? To what extent and why the transition experience of Ukraine is different from that of other countries undergoing economic transformation? This section of the book provides some answers to these questions and serves as the basis for a deeper analysis of Ukraine's transition experience that follows later in the book.

Initial conditions

A strong effect of initial conditions on economic performance during the transition, especially at its early stage, is identified in many studies (Castanheira and Popov, 2000; De Melo et al. 1997, Guriev and Ickes, 2000, Havrylyshyn et al., 1999). However, the magnitudes of inherited distortions and the impact of initial conditions on economic growth were far from being universal across countries.

There are many reasons to believe that a number of structural and institutional factors made Ukraine's initial position less favorable than that of other transition countries. However, a number of legacies can well turn into advantages under a thoughtful government policy. We describe some pros and cons of Ukrainian initial conditions below, and compare Ukrainian legacies with those faced by Russia and Latin America.

At the start of the transition Ukraine had the highest share of large-scale industrial enterprises and was the second largest (after Russia) industrial producer in per capita terms among the CIS countries.² With 3 percent of the USSR territory and 18 percent of its population Ukraine produced 16.7 percent of the USSR industrial output. For comparison, Russia had 61.9

² Latvia and Lithuania had slightly higher industrial output per capita than Ukraine (but lower than Russia). However, the industrial structure of these states was more consumer-oriented as compared to that of Ukraine, which gave them an advantage during the transition.

percent in the USSR industrial output with 76 percent and 51 percent in its territory and population respectively.³ (more in Subsection 3.2) Such structure of the economy made Ukraine more vulnerable to the process of economic transformation than any other (with the exception of, perhaps, Russia) country of the FSU. However, the major problem was caused not even by the fact that deindustrialization and the changing industrial structure entailed high costs in terms of output contraction and shedding of the labor force. As we argue further, the key consequence of overindustrialization in Ukraine was creation of the powerful industrial lobby making its best to retard any effort of market-oriented reforms in order to preserve the existing sources of rents. It is argued (Economic Reform..., 2000) that it is more difficult to get any legislation through the Ukrainian Parliament than to do so through the Russian Duma because of the very fragmented nature of the former (making it difficult to buy the necessary number of the "right" votes). However, if reforms do not touch the business interests of members of the Parliament, and are supported by request from the Presidential Administration, the Parliament members will vote even for the Land Code.

The creation of Ukraine's industrial sector, non-competitive worldwide, reminds Latin America in 1960-1970s. The Latin American governments have experimented with policy of import substitution too long, which led to the inefficient resource allocation, stagnation of exports of manufacturing goods, agricultural decline and chronic negative balances of payments. The Latin American model of development, dating from the 1950s, calls for the government intervention in a number of main sectors, including manufacturing, in order to accelerate development. For many state enterprises, however, "political considerations interfered with economic management, budgets were overspent, and the market was not available to discipline behavior. The results were often disappointing, with many inefficient state-owned enterprises (SOEs) draining public finance" (Economic and Social Progress in Latin America, 1996).

The prevalence of loss-making energy-intensive sectors in the industrial structure of Ukraine made the economic situation in the country after the restoring independence quite difficult due to a high reliance on energy resources. While Russia accounted for 91 percent of the total ex-USSR oil production, the share of Ukraine was a mere 0.9 percent. That clearly made two highly industrialized economies face different perspectives after becoming independent states. At the time when Russia could take advantage of rising world prices on energy products, Ukraine became highly dependent on energy resources and was subject to large terms-of-trade shocks. About 60 percent of Ukraine's demand for fuel is satisfied

³ Karasik T. (1997), "USSR facts and figures annual, 17", p. 154.

through imports, including, 100 percent of nuclear fuel, 77 percent of the natural gas, 15 percent of coal and more than 85 percent of oil. The main energy supplies come from Russia and Turkmenistan.

There is a large body of growth literature suggesting that resource abundance can be associated with more problems for the economy than resource scarcity. Indeed, the growth performance of many resource-rich Latin American countries is far from being convincing (Rodriguez and Sachs, 1999; Sachs and Warner, 1995). "From 1963 to 1996, Venezuela sold USD 329 billion (in constant 1995 U.S. dollars) of fuel exports to the world – USD 20,420 per Venezuelan. However, in 1997 Venezuela's GDP was 8 percent lower than in 1963" (Rodriguez, 2000). In Tornell and Lane (1994) it was proposed that resource booms could lead to an expansion of rent-seeking activities.

In the Ukrainian context, one could at least expect that a lack of energy resources would result in a faster restructuring of energy-intensive enterprises, introduction of the energy-saving technologies and generally limited opportunities for the energy-related rents. The Ukrainian experience is indeed unique in that nothing of the above has happened. The government policy of energy subsidies to industrial producers conducted under the pressure of rent-seeking industrial lobby provided little incentives for enterprises to adopt energy-saving technologies and diverted away a large chunk of state resources that could be alternatively used for the benefit of the economy. Moreover, having very limited resources for accumulating export rents a number of businessmen supported by high-ranking government officials engaged in a dirty game of importing energy from Russia at below the world market prices and under the state guarantees to pay, and selling it abroad. Needless to say that as a result of such operations the state was left with huge external debts to pay (at the expense of pension and wage arrears and/or the placement of T-bills and Eurobonds at the exorbitant rates) while the declining economy was further stripped off. The problem of rent seeking will be discussed in a greater detail in Subsection 3.3 as it obviously plays a crucial role in explaining Ukraine's poor performance.

In 1990, one-third of Ukraine's GDP was produced by the military-industrial complex (MIC). Declining defense orders and worsened, after the breakup of the USSR, links with producers and end-users of Ukrainian components, led to the reduction of the size of the MIC. A total labor force in this sector declined from 2.7 million people in 1990 to 1 million people in 2000. The Pivdenmash plant in Dnipropetrovsk, the world's largest rocket missile factory has experienced the reduction in labor force from 50,000 people in 1991 to 10,000 today. It is a subject to severe competition from Russia and the West, and a search of new sales markets and contracts is crucial for its

survival. The predominance of industry in the economy is generally associated with scientific knowledge and highly skilled labor force. High quality of human capital in Ukraine can be clearly seen as a positive legacy of the Soviet era. However, to deliver the benefits for the economy these skills need to have application in the new market economy, otherwise they become obsolete. In Ukraine, job destruction up to date was far exceeding job creation leading to a negative employment growth rate and degradation of skills for those who became unemployed, or, in a depressed labor market, assumed jobs not related to their main training and specialization. In these circumstances it is only the orientation toward skill-intensive production that can provide a solution.

Ukraine inherited the most fertile land in Europe (30 percent of the world's black soils). The estimates of total value of agricultural land – arguably the country's single most important natural resource – vary from over USD 35 billion by (OAB, 28/02/2000) to USD 70 billion, according to the Ukrainian specialists (Harbuz, 2001). Agriculture has traditionally been one of the largest and most important sectors in the Ukrainian economy. With a 3 percent of the ex-USSR territory Ukraine generated one-fourth of the total agricultural output. Having a historical reputation of a European granary (Havrylyshyn, 1999), Ukraine, paradoxically, had to import 1 million ton of food wheat in 2000 (OAB, 29/09/2000). The 1999 harvest was the worst since 1945! It is clear that the three consecutive years (1998-2000) of bad harvest cannot be blamed on unfavorable weather conditions. The sector's declining performance obviously has deep-rooted structural problems as its explanation (to be considered further).

Actually, it reminds shortage of food in Argentina in mid-1940s, where meat and wheat comprise the main exports, as well as that in Brazil and Mexico. This was explained by a low productivity of agriculture and semi-feudal nature of large agricultural enterprises, which resemble the recently dissolved Ukrainian collective farms.

Macroeconomic policy

There is an increasing recognition in the growth literature that macroeconomic stabilization, which usually assumes low budget deficit, low inflation and stable exchange rate, is a necessary, but not sufficient condition for economic growth (Berg et al., 1999; Fischer et al., 1996). If anything, the evidence indicates that it is only inflation above some threshold level that hurts growth (Havrylyshyn et al., 1999; Christoffersen and Doyle, 2000).

The fact that in several transition economies the success in curbing inflation was not followed by growth recovery suggests that monetary

stabilization itself is void for growth. Ukraine can be cited as a good but very bitter example here. After having the highest inflation rate among transition countries in 1993 (10,155 percent)⁴, Ukraine managed to depress inflation to 10 percent in 1997 and kept it below the CIS average since then. However, despite this relative success in implementing macroeconomic discipline, the output was continuously declining until year 2000. These developments indicate clearly that economic recovery and sustainable growth are not possible if monetary discipline is not supported by profound changes in the institutional environment in which the firms operate. As soon as the soft budget constraints (SBC) were not eliminated, open subsidies were just substituted by the hidden ones and the “virtual economy” has emerged.

Latin America has also experienced high inflation times. During 1960-1997 inflation averaged 105.7 percent, which was far above average in all world's regions except “new transition” economies (World Bank, 1997). There are only seven countries in which the average inflation rate exceeded 100 percent over the period from 1971 to 1997; five of them (Argentina, Bolivia, Brazil, Nicaragua and Peru) are in Latin America (Rodriguez, 2000). The results obtained in (Rodrik, 1998) suggest that Latin American combination of high inequality and poor institutions is one of the key factors behind its problems in achieving low inflation.

In Ukraine, unfavorable institutional climate did not prevent the restoration of relative macroeconomic stability, but this stability was of a little help as structural reforms were stalled.

Structural reforms

The growing evidence suggests that structural reforms play a key role in determining growth outcomes (Berg et al., 1999; Christoffersen and Doyle, 2000; Havrylyshyn et al., 1999). The experience of Latin America and CEE countries suggests that it is the success with implementation of structural reforms that largely determines the long-run economic performance, although the initial *stock* of reforms also matters a great deal (Coricelli, 1998). Those countries that introduced at least some rudimentary elements of market reforms *before* the transition (mostly CEE countries) performed markedly better (in terms of both the pace of further reforms and economic outcomes) than the rest during the transition.

What is the absolute and relative progress of Ukraine with structural reforms during the transition? Although some progress has been made in many directions (Table 2), overall Ukraine's advancement in reforms was behind that of all CEE and most of the FSU countries. It is also the quality

⁴ The National Bank of Ukraine (NBU) Bulletin, December 1999, p. 49.

of changes rather than their quantity that makes the difference. For instance, both Ukraine and Russia significantly privatized their economies over the 1990s (although Russia privatized more), but the quality of Russian privatization is argued to be better than of the Ukrainian one (Economic Reform..., 2000). Ukrainian privatization was dominated by insiders who often had low incentives for undertaking serious enterprise restructuring. The privatization process in many cases was viewed as merely a mechanism of acquiring ownership and was not followed by deep restructuring.

The efforts of the Parliament to take control of the privatization process under the pressure from private lobbies and regional elites, the ongoing battle between the executive and legislative branches over the issue of privatization, and an extensive list of companies "protected" from privatization significantly stalled the pace of privatization in Ukraine.⁵

The difficulty with privatization, however, is not a Ukraine-specific problem. The most common barrier to privatization in 1990s in Latin America has been opposition by labor unions and political parties. Bureaucrats and their unions have gained from secure and relatively high-wage public sector jobs. "The prospect of eliminating 100,000 state sector jobs has generated so much opposition in Paraguay that the government has been stymied in attempts at privatization" (Social and Economic Progress in Latin America, 1996).

The ongoing privatization in Ukraine is often non-transparent and leads to the sales of attractive state assets for nothing. There have been many cases of "latent" privatization, whereby very liquid state property is sold ostensibly in order to honor creditor claims. For instance, in April 2001 three thermal plants belonging to Donbasenergo were sold for UAH 206.9 million to service creditor claims amounting to just UAH 4.8 million. A month later a 49 percent stake in Rosava, Ukraine's largest producer of car tires with total annual sales of UAH 450 million, was sold for debt for a mere UAH 4.29 million (OAB, 6/6/2001). The government failed (purposefully or not) to prevent this kind of sales.

The lack of effective ownership restructuring in Ukraine is perhaps the most evident from the poor performance of its agriculture. Until 2001 Ukraine's agricultural sector has played a role of national embarrassment rather than of national pride. This indicated clearly that the effective landowner was lacking in Ukraine. The privatization of collective farms often has not gone far further than sharing collective farms with their obsolete equipment among members. At the beginning of 2000 only 15 percent of farmland

⁵ In terms of obstacles to privatization, though, Russia does not seem to be doing better than Ukraine. The Russian government is forbidden from undertaking privatization of large enterprises without the Duma's prior approval, and many companies have been on the privatization agenda for years without ever being sold (OAB, 5/5/2001).

was cultivated by the private sector in the form of household plots and family farms. Subsistence farming (dacha plots) accounts for an increasing share of agricultural production. The positive development is that the number of private farms is growing, and it is estimated to have reached 42,311 on April 1, 2002. The area of arable land in hands of farmers grew 2.5 times during January 2000 – April 2002. Despite many administrative and legislative hindrances to the agricultural reform, Ukraine yet is judged to do better than her neighbors on this front of reforms. The issuance of 6.5-million private land property rights registration certificates and legislative approval of the new Land Code are considered as significant steps for the creation of new class of land holders in Ukraine and the realization of her potential in the agriculture. We believe that under the effective ownership agricultural sector in Ukraine promises to deliver high growth rates in the years to come.

Despite the urgent need to restructure the Ukrainian coal sector the progress has been absent. Out of 252 coal mines, 30 percent (75 mines) produce just 5 percent of overall coal output. The average cost of Ukrainian coal is 150 percent of the selling price. That is, the profitability is negative 50 percent. At the same time, state subsidies to the coal sector 1.5 times exceed budget expenditures for R&D. Although annual coal output halved over the last decade, the number of employed in this sector dropped by only one-third. The share of barter in the total volume of the coal-related transactions reaches 60-70 percent, and a large number of intermediaries in the industry give room for fraudulent practices.

In contrast to the Russian stock market, the Ukrainian one has never really taken off as the rights of the shareholders have been neglected. The capitalization of securities market is about 9 percent of GDP, compared with 20-30 percent on average across Eastern Europe. The trading volumes are notoriously low, and 5 percent of all listed firms account for 95 percent of market turnover. The overall volume of foreign investment in the banking sector remains a modest 15 percent, compared with 65 percent in Hungary and 70 percent in Poland (OAB, 20/09/2001). With the total capitalization equal to one large bank in Central Europe the Ukrainian banking system remains severely undercapitalized. Except the insurance industry, which experienced a rapid development recently, the non-bank financial institutions (such as pension funds and mutual funds) are virtually non-existent.

To sum up, although some achievements have been made in structural reforms, the process of restructuring has far from being satisfactory. We argue that the major explanation for the slow pace of structural reforms in Ukraine has to be found on the institutional side.

Institutional environment

When discussing the progress with structural reforms in Ukraine we have to bear in mind that it (or lack of thereof) depends much on to what extent institutional environment is supportive to and pushing for reforms. De Melo et al. (1997), and Heybey and Murrell (1999) find that both the extent and speed of reforms are strongly influenced by initial conditions and institutional factors. Political instability, a lack of institutions making economic rules work, weak law enforcement, poor protection of property rights, and corruption may significantly, if not completely, hinder the process of development. The important question to be answered is then: How the quality of institutional environment in Ukraine compares to that in other transition countries?

The level of corruption in Ukraine is among the highest in the world. The 2001 Corruption Perception Index (CPI) ranks Ukraine 83-rd among 91 countries (Table 9). For comparison, Russia and Ecuador are both ranked 78-th (meaning less corruption), Mexico – 51st, Colombia – 50th, Brazil – 46th, Poland – 44th, Slovenia – 34th, Hungary – 31st. The poor quality of institutional environment and resistance to economic reforms from those rent-seeking forces in a society that would lose their privileges as reforms progress, are increasingly recognized as the main impediment to economic performance of Ukraine.

Despite a decade of the transition institutional climate in Ukraine remains unfavorable and is worse than that in the FSU on average, with the latter ranking behind that in the Baltic States and CEE (Tables 2 and 3). That per capita cumulative FDI inflows into Ukraine during 1989-1999 were among the lowest in the region⁶, and that Ukraine's sovereign bonds are rated below junk bonds leading to high costs of borrowing (Table 4) reflect probably better than anything else the perception by foreign investors of its institutional climate.

Ukraine is very similar to Latin America in that her authorities turned a blind eye on the main pre-requisite for sustainability of growth – progress in institutions. Nowadays the words of Mario Vargas Llosa may be applied both to Latin America and Ukraine: "We have democratic governments, but our institutions ... are very far from being democratic. They remain populist and oligarchic... flawed by social prejudices..."

Ukraine's administrative reform that started in December 1999 has stopped just four months later. The Prime Minister V. Yushchenko failed to subordinate such vital bodies as the Customs and the State Tax Administration to the Finance Ministry, and some old Ministries have been restored. The only positive result were the changes in the procedures of

⁶ Ukraine's per capita cumulative FDI inflows over 1989-1999 reached 55 USD, as compared, for instance, to 494 USD in Kazakhstan, 518 USD in Poland, 866 USD in Latvia, 1,447 USD in Czech Republic, and 1,764 USD in Hungary (EBRD Transition Report 2000, Table A.3.9, p. 74).

decision making in the Cabinet and lowering of the status of the Ministry for Industrial Policy. However, this ministry, a home of protectionism and paternalistic policy that effectively discouraged enterprise restructuring, was restored immediately after the dismissal (by a communist-oligarchic coalition in the Parliament) of Yushchenko.

The growth recovery of 2000-2001 is under a risk of severe setbacks if the administrative reform fails to be carried on. It is clear that without drastic improvements in its institutional climate Ukraine severely jeopardizes its growth prospects, as it has happened in the "old still transition" Latin American countries.

We provide a detailed analysis of the major institutional obstacles to economic growth in Ukraine later in the book.

Identification of the main problems hindering Ukraine's economic performance

The transition from the central planning to market economy was often viewed as a shift from the economic policy that operates exclusively through the resource supply to the policy that indirectly supports a certain incentive structure and focuses mostly on the macroeconomic stability. Under these circumstances, privatization was regarded as a sufficient condition for creating the right economic incentives and actors.

Now most economists seem to agree that this initial simplistic approach to transition has suffered from numerous shortcomings. Particularly, the unfair privatization, especially its mass (voucher) method, has been blamed for many undesirable outcomes (for example, the recent Nobel Prize winner J. Stiglitz was one of the well-known critics of this approach). Although it is hard to imagine the transition without privatization, the latter should be viewed as a necessary but definitely not sufficient precondition for the transition success. Other building blocks of the transition road – liberalization, tight monetary policy and fiscal stabilization – have also proved insufficient or infeasible in some cases. What additional conditions are necessary for a successful transition then?

Today, we admit that these conditions (whatever they are) seem to be met in some countries, such as Poland, and are not met in many others, such as Ukraine. Among many possible factors affecting the transition are vague property rights distorted by the discretionary power of state bureaucracy (Shleifer and Frye, 1997); the capture of state authorities by vested interests (Hellman and Schankermann, 2000); poor contract and tax enforcement resulted in a “bad equilibrium” and low budget revenues, high corruption and large unofficial sector (Hellman, Jones, and Kaufmann, 2000); or a sort of implicit “social contract” between the powerful interest groups to support SBC (Kornai, 1992) by means of “virtual economy” (Ickes and Gaddy, 1998). (World Bank, 2002) have generalized the most important factors in two key concepts: “discipline” (that should be imposed on the old sector), and “encouragement” (that is necessary to boost a new sector). Their importance is supported by empirical studies and we prove that in Ukraine all of the listed phenomena clearly took place.

As we have already mentioned, Ukraine has inherited from the Soviet era a bouquet of adverse initial conditions. However, a decade of transition clearly suggests that the adverse initial conditions per se are not the main culprit of the sluggish reforms and poor economic performance. The

explanation has to be found in understanding what kind of the institutional environment the inherited distortions create and support. From the point of view of the institutional theory (North, 1990) the explanation for the observed pace of reforms can be easily found: the rate of transformation of the formal institutions is endogenous.

However, this assertion about a strong “path dependence” of the transition process is vague; further efforts are needed to make it “operational” both in terms of evidences and policy implications. We present such evidences in our book. Following (Putnam, Leonardi, and Nanetti, 1993) we focus on economic actors and political actors, since due to the thin division line between branches of power, politics in transition is inseparable from business. These actors are a product of specific historical paths.⁷ We argue that for market incentives to become effective a competitive market selection of firms’ managers and owners with appropriate business culture must be put to work. The job of the invisible hand is to create the right incentives and to bless the true decision makers, especially, the CEOs who run the companies. A market economy provides competition, an effective mechanism for selection of the most capable and motivated personalities. This process of competitive selection is a subject of the evolutionary economics (Nelson and Winter, 1982, for the survey see, e.g., Nelson, 1995). Another reason for employment of an evolutionary approach is the fact that transition is first of all a tremendous structural shift, namely, quite rapid evolution. As soon as an economy in transition is far from the efficient equilibrium (“neoclassical nirvana”), the evolutionary approach to explaining transition is the best applicable one for the same reasons as described, for example, in (Verspagen, 2002).

We focus on the selection of business and political leaders, because the economy’s structure and behavior is largely determined by prevailing economic behavior of the firms and the State. Contrary to the widespread opinion, this behavior is determined primarily not by the overall informal institutions dominating within the particular society, but by relatively minor number of the political, administrative and economic elites’ members that may substantially differ from the average in their abilities and preferences. Thus, besides the informal institutions that are admittedly stable, economic behavior is a product of three additional factors, which can be a subject to external control: available human capital, market incentives and a

⁷ We may suggest the following example to illustrate this concept. Let us take three identical samples of the same sort of fine steel. We then heat up two of them in the oven. Next, let us temper one of the heated and draw back the other one. After these manipulations, let us try to maul each of them with a sledgehammer. The untouched sample will remain undamaged; the overtempered one will be broken; and the drawn back one will be flattened. So, different reaction to the same shock reflects the different microstructure that each of them has got due to the different historical path.

mechanism of selection. While much attention was paid to the first two factors (World Bank, 2002), the mechanisms of a competitive selection still remain not well studied and undervalued.

But, as stressed in the evolutionary economics, for these mechanisms to operate the appropriate institutional conditions should be in place. As well as a competitive selection determines the pace and direction of the structural changes, market institutions should not only facilitate the simple everyday economic activity, like selling goods (hence powering the products' market invisible hand), but also arrange the full-fledged competitive selection of market actors, by augmenting market entry and exit, as well as the takeovers and enterprise restructuring. On the other hand, if some powerful actors are rent seekers, they can effectively impede any institutional changes that allow for competition and hence potentially jeopardize their monopoly. While preventing a competitive selection and thus securing their sources of rent, Hellman's "intermediate winners" at the same time often destroy the institutional arrangements of the product markets too. In this way they obscure the establishment of the basic market institutions designed to protect property rights, contract enforcement, etc. To prevent the undesirable selection the weak actors may either lower incentives (hence suppress the product market, as in non-competitive transition economies like Belarus, Uzbekistan and Turkmenistan) or suppress directly the selection mechanism, as it happened in the bankruptcies and capital/management market in concentrated economies like Russia and Ukraine (World Bank, 2002). In the first case, the institutional performance is relatively equal for different types of markets and results in the lower decline, but at the same time in the poorer incentives for the structural changes.

Therefore, the lack of competitive selection leads to the suppression of the "good policies" in all spheres and the peculiar economic and political behavior of both the firms and the State – the behavior quite different from that observed in advanced economies. As a result, even the "right" market incentives may end up in wrong outcomes (Gaddy and Ickes' virtual economy). Moreover, the market mechanism may end up being distorted or even perverted by the state capture, so that actual incentives will act in the opposite direction, as we observe in the energy-intensive industries of Ukraine (Subsection 3.3). In the energy scarce country this leads to the disastrous deadweight losses that are partly responsible for the unexpectedly deep economic decline in Ukraine during the 1990s.

The state capture (World Bank, 2002), in turn, results in the macroeconomic instability and deterioration of human capital. From the above described perspective we add that due to the opposition of incumbent economy/policy actors, the market institutions necessary for a

competitive selection are especially fragile in transition. They constitute a sort of “institutional bottleneck” for other reforms. Moreover, as we have mentioned before, the institutional (and information) asymmetry may be even more important factor of economic decline than the overall weakness of the market institutions.

But why the market selection of economy actors is so poor in Ukraine, and relatively strong in Poland? Why the necessary reforms turned out to be so arduous? And, what the mechanism led to the peculiar symptoms, very similar to the Dutch disease ones, but observed in the energy-scarce Ukraine?

Certainly, the set of mutually related factors – economic policies, various forms of rent seeking, historically formed composition of the elite and economy, external shocks, etc. is likely to be at play. In our book we attempt to discover some specific factors that are particularly important in explaining Ukraine’s pattern of transition. In the Subsection that follows we provide some theoretical explanation of the interrelation between these factors. The role of the adverse initial conditions in creating and supporting institutional distortions is described. Then, in Subsection 3.3, we study in detail the case of the energy-intensive sectors as a rent pump in Ukraine. The other mechanisms of rent seeking are also considered.

Subsection 3.1: Why the Ukrainian elite resisted reforms so badly? *Theoretical foundations*

a) Resource-Oriented Policy

For the economy to grow it should have some resources (such as investment capital) available; institutional environment facilitating right incentives (like those provided by the competitive market pricing) for the efficient allocation and utilization of these resources; and the right actors capable to use the resources efficiently and follow the market incentives. Respectively, the economic policy can be focused on each of these components. Economic policies differ in their treatment of the resource shortages, demand declines and terms-of-trade shocks. Consider, for instance, a shortage in some resource that increases its price. In response to such a shock:

- The **resource-oriented** government tries, first of all, to boost the volume of resource supply, or introduce subsidizing in order to maintain the levels of production and employment **by any means**. This kind of policy is an activist one by definition and has much in common with paternalism, since it is aimed at supporting the

existing business entities. The main difference is that paternalism in its exact meaning (Kornai, 1992) is essentially irregular, unpredictable form of support with vague and non-transparent rules of the game, whereas the resource-oriented policy (ROP) is a broader concept that also includes the open and hidden subsidizing, which can be impersonal and pretty transparent, but equally distorting. The subsidizing of inputs seems to be the most characteristic and, perhaps, the most harmful form of such a policy;

- The **incentive-oriented** government usually abstains from direct intervention and allows the market incentives to do their job (the “night watcher” policy), or tries to stimulate certain desirable developments (one kind of the activist policy). Artificial incentives implemented prior to the expected shocks to force economy actors to the advance adjustment (as the European-type excise taxation of gasoline) may serve as an example of a wise incentive-oriented policy. The tax exemptions introduced in 1992-1994 in Ukraine allegedly for attracting foreign investment is the example of the ill-thought policy. The difference of the incentive-oriented policy from the resource-oriented one is that it either forces the firms to behave in certain way or shows them a “carrot” that will be given just after some action or change in behavior.
- In the advanced market economy the special policy towards economic actors’ selection is less pronounced, since the corresponding market institutions function quite well. Nonetheless, there are market failures in this area that a benevolent government should try to alleviate. The components of this **selection-supporting** policy include fair play control, the pro-competition policy, protection of the property rights, support of a small business, disclosure of information, etc.

The resource-oriented policy is the kind of economic policy that serves as an instrument for rent seeking in the process of re-distribution of resources that favors the “winners” at the expense of the “losers”. The well-known effect of the ROP is the wasting of resources and deterioration in market incentives. That results in the inevitable decline in efficiency. But it is often stressed that incentives can be theoretically changed literally overnight by changing the formal institutions. To do that, nothing but a “political will” is needed. The magic transformation, nevertheless, does not happen in Ukraine. To explain why it is so, we should stress the long-run effect of rent seeking/ROP that manifests itself via the market selection system.

The components of such system should be:

- labor market for managers,
- competitive market investment infrastructure, and
- hard budget constraints (HBC).

The first one allows successful owners to employ the best managers; the second one directs capital toward the best owners; the third one directs assets away from the worst managers and owners. Both capital and manager markets must be augmented by adequate institutions, including hard budget constraints. That is also necessary to make firm's performance measurable. But the paternalism is just a synonym of soft budget constraints. Moreover, a "hard" subsidization of resources (inputs), as well as any other form of protectionism, clearly hurts selection by discouraging a fair competition.

The more discretionary and paternalistic is the ROP, the more probable is the adverse selection of management. While in the market economy the quality of management usually complements a capital because richer owners can employ the better managers, in the paternalistic system these two factors are rather substituting each other. If the State commits to support existing entities regardless of their efficiency, the less efficient (*ceteris paribus*) firm may end up with more capital if it can prove that its poor performance is caused by lack of investments. That was a common tactics of getting favors under the central planning.

Then, whenever a resource-oriented paternalistic authority has a power to support an individual firm or a sector with resources or protection, this support becomes a source of potential rent incomes for both the firm and a respective official. Moreover, the government bureaucrat gains the informal property rights to the extent the firm needs such a support. Thus, the more vulnerable and susceptible is the firm, the more potential rents can the patron squeeze out of it. This kind of relations is described in (Lambert-Mogilyansky, Sonin and Zhuravskaya, 2000) for the particular case, but their model can be also applied for the general case of patron-client relationship in the paternalistic economy. It is clear that the relatively weaker firm leaders (CEOs and owners) will be selected each time, even despite the overall inclination of the authority for the overall increase in welfare.⁸

⁸ Precisely speaking, this is true only if the grabbing hand is not in force (the authority is limited in the enhancement of the discretionary power). Otherwise the authority can impose the bribery tribute on everyone regardless of its vulnerability and the situation becomes quite similar to the traditional Eastern despotism where bribery payments are inevitable for all actors and the authority is clearly interested in selecting the most capable ones to maximize the gains. But the grabbing hand itself allows for the discriminatory bribing and hence reduces incentives.

Thus, the ROP inevitably leads to the deterioration in efficiency. In the energy-scarce country such as Ukraine this policy is clearly unsustainable in a long run. We next point out the link between the rent seeking and ROP.

b) The resource-abundance and reluctance to reforms: the role of institutional memory

We define the rent as some income resulted not from value creation, but either from:

- (1) re-distribution of the value created by others; or
- (2) utilization of the natural resources or other factors not created by the present generation (like location, history, heritage, etc.).⁹

Further, we distinguish between macro and micro rents, meaning, respectively, the rents for the country as a whole, and for the economic actors within the same country. Importantly, both can be either of the first sort (re-distributional) or of the second one (Table 5). While the macro rents can improve welfare, and, under certain circumstances, can be even the resource of growth, the micro rents are regarded as predominantly growth prohibiting factor, mostly because they affect incentives, and thus advert efforts from the productive activities (Shleifer, Murphy and Vishny, 1993). Nonetheless, under certain circumstances (an institutionally weak government but well-protected property rights) they can be beneficial for growth if the capturers of natural resource related micro rents can invest them into the domestic economy more efficiently than the government does. That is not the case for Ukraine and Russia, however, where accumulated micro rents flew the domestic borders in the form of capital flight. These rents may become beneficial again only if some day they return home in the form of FDI or as bank's deposits.

The natural resource abundance, the main traditional source of macro and micro rents, was characterized in the literature as a "mixed blessing" (Gylfason, 2001; Sachs and Warner, 1995). While providing a country with additional income, the abundant natural resources bring the risk known as the Dutch disease (in a broad sense – Gylfason, 2001), especially if these resources are easily extractable and tradable, such as oil and diamonds. This "disease" has three main well-known "symptoms":

- the crowding out effect on activities not related to the rent-gaining sector, primarily high-effort goods;
- the micro level rent seeking; and

⁹ With the obvious notation that the extraction of these resources (mining, drilling, or, say, tourist business) is clearly the value adding activity.

- overconfidence.¹⁰

In the case of natural resource abundance (Figure 1) this purely exogenous factor is a primary source for both rent-related currency inflows at the macroeconomic level and the institutional hazard. Does it necessary mean that the above-mentioned symptoms are determined exogenously?

Gylfason, while admitting the negative impact of resource abundance, provides an insight that such an impact is avoidable. For instance, if State institutions are strong enough, as in Norway, the Dutch disease (DD) is not observed. Thus, not the macro rent *per se*, but the development of poor governance institutions of specific sort that comes as a consequence of availability of this rent, is the necessary cause for DD. Is it also a sufficient one?

If this is the case, a syndrome similar to DD may be observed in a country with that sort of poor institutions even without the actual natural resource abundance or any other source of a long-term macro rent. Certainly, the macro rent in this case is of the re-distributional kind, hence its source is not mandatory exogenous. To distinguish this syndrome from the “true” Dutch disease we call it a “pseudo” Dutch disease.

One of the possible examples may be a country that has suddenly been deprived of the natural resources, for instance, with empire’s breakdown. As we show in Section 3.3., a set of symptoms very similar to those of DD was observed in Ukraine with the energy-intensive industries as a rent-gaining sector, despite the actual scarcity of energy resources. Below we prove that this similarity is not just a co-incidence, but reflects a path dependent (North, 1990) “institutional memory” of the economic and political system. The individuals and organizations used to certain, primary rent-seeking and rent-related, activities that became “routines” (Nelson and Winter, 1982) for them under the circumstances of resource abundance. After loss of their habited rent they persist in trying to call its “ghost” (Figure 2) If they succeeded, as it happened in Ukraine, they can extend the DD

¹⁰ Noteworthy, the natural resources are the most common, but not the only source of a macro rent. Any sort of rental (unearned) income gained by the country can equivalently cause a sort of Dutch disease, since any kind of rent distorts the incentives (produces overconfidence); crowds out the value adding activity (leading to the structural deterioration); and undermines the public moral (resulted in the rent seeking at the micro level). The extent of the disease, however, depends on the time horizon and responsibility of the ruling elite. For instance, the borrowing of an irresponsible actor with a short time horizon can be regarded as a sort of “virtual” rent income, since this income is unrelated to the value adding activity and this actor does not really believe that it will pay it back, otherwise this deal is counter-rational. Evidently, at the macro level this kind of activity is the re-distributional one if it is followed by a default; otherwise it can be characterized as the intergeneration re-distribution within a country.

symptoms that are beneficial for them with the help of the re-distributional temporary macro rent, which we call a “virtual” one.

But it is not enough to state that institutions are path dependent. What is the mechanism for this institutional memory? How does this “path dependence” operate? Further in this section we show the way it works in the particular case of energy-scarce Ukraine that for 70 years used to be a part of energy-abundant Soviet Union.

We start from the notion that the micro level rent seeking related to the natural resources is usually owed to the fact that rent incomes related to the resource extraction are easy to capture – there is no need to employ the State (in a broad sense), just to keep it aside. But even if the State extracts all the rent (like under the central planning), macro rent incomes allow the irresponsible government to pursue the ROP and waste macro rent gains for the paternalistic support of the existing (non-competitive) entities. Both government and firms get used to respective routines that are conservative and prohibit full-fledged selection mechanism in work to evolve (Nelson and Winter, 1982). In addition, the ROP allows converting macro rents into the micro ones with all respective vested interests.

As soon as the ROP is a source of micro rents for the economic actors, they may support such a policy by sharing their rents with policy makers. It is one of the main reasons for authorities to support the existing entities. But doing this the government creates a specific sort of a negative Putnam’s “social capital” – a dense and persistent web of informal network strongly tied by the corruption links in business and bureaucracy. On the other hand, the ROP suppresses the competitive selection of profit-seeking and capable actors – perhaps, the only effective remedy for this disease. If such a policy is supported by a source of macro rent, then it can sustain for long enough – that is another symptom of DD, the overconfidence. While relying on the rents from resource mining, or the export of cheap energy resources, the government may rest on its laurels. This postpones the necessary structural and institutional reforms that would cease rent seeking and non-productive activities and allow the market selection of the respective economic and political actors. Finally, such course of events is detrimental to the public moral.

Then, even when the natural source of rent disappears, the inseparable alliance of business and bureaucracy would try to pursue their habited routines and hardly allow for any reforms as soon as they are potentially subversive for the existing elite. We call this propensity “reluctance to reforms”. That is exactly the case for Ukraine in the 1990s, where the inclination toward the ROP and postponement of the reforms by the ruling elite was clearly intentional, since it was the source of micro rents shared between the privileged businesses and their supporters among government

officials. Being deprived from the natural source of a macro rent this elite was faced with a choice “to reform or to die” – to limit their rents and power voluntarily, by reform, or to be dismissed by a social unrest. But there is an escape from this choice. If such a government can find an (even a temporary) alternative source of macro rent, it can afford to postpone the risky (for the generation of rents) reforms and continue its habitual lifestyle. This “virtual” macro rent brings many symptoms that are usually characteristic to DD. However, contrary to the general case, not the resource abundance brings it, but the inability of the ruling elite to sustain without retaining macro rents. That is what we call the “pseudo” Dutch disease (Figure 3).

Another long-term factor explaining Ukraine’s bureaucracy resistance to reforms and owed to the resource abundance in the past is not directly related to the rent seeking. It is the allocation of both human and physical capital in favor of the primary sector or low-level processing. Whilst such allocation is natural for the resource-abundant country, it brings risk of painful structural reforms in the case of price shocks (e.g., the discovery of new deposits abroad or exhaustion of resources). The good example is coal mining in Europe that became noncompetitive to the imports of quarried coal.

To sum up, we have shown some theoretical reasons for the resource-scarce economy to pursue the ROP and create “pseudo” macro rents. These reasons are mostly related to the adverse selection of economic actors and proliferation of rent seeking, and partly to the problems with human and physical capital that make a system reluctant to reforms.

But in the case of Ukraine there are a few more factors causing such reluctance.

c) Adverse selection of elite and paternalism

To understand the reasons for the sluggishness of economic reforms in Ukraine we have to look at some other factors as well. The reform-oriented efforts clearly depend on the quality of the country’s elite. The position of Ukraine on this front, however, was quite weak. During the last decade the Ukrainian ruling circles were dominated by the ex-Soviet nomenklatura members. This “new” Ukrainian bureaucratic elite was cautious, indecisive and mostly incompetent. Suddenly they have found themselves in the energy scarce Ukraine and the magnitude of revealed distortions palsied these policymakers with fear.¹¹ Evidently, the economy required drastic

¹¹ In 1992-1993 the parliament commission headed by Prof. I. Yukhnovsky has concluded that most of the Ukrainian ferrous metallurgy and coal mining is non-competitive in the world prices. The commission was immediately dissolved and its findings were restricted.

and comprehensive reforms in response to the challenges. The Soviet era type elite, however, was not prepared for this mission.

After a defeat of the Ukrainian Republic in 1917-1921 thousands of the most pushing, capable and dynamic elite members emigrated. After a short period of Ukrainization the Stalin's clique reversed its policy and set up a regime of terror. More than 7 million Ukrainians died during the artificial famine in 1933-1934. Fearing a threat of prosecution for the Ukrainian "bourgeois nationalism", thousands of educated economists, lawyers, mathematicians and managers had to leave the country. Among members of the Union of Ukrainian writers only 80 out of 420 escaped concentration camps. No ethnic Ukrainian was appointed to the leading position of the first secretary of the local branch of the Communist Party until 1945. Ukraine has also suffered huge losses totaling more than 6 million people during the World War II. The second after 1945 wave of emigration has accounted for more than 300,000 young Ukrainians.

After Stalin death times have changed. However, it was still easier for ethnic Ukrainians to be promoted to managerial positions in Siberia or in Kyrgyzstan than in Ukraine. In times of Brezhnev who had Ukrainian roots and was ruling the USSR for almost 18 years, the local nomenklatura, dreaming about higher positions in Moscow, had no incentives to improve the situation in Ukraine. One of the last Communist rulers in Ukraine V. Shcherbytsky had "reigned" during 1972-1989. His period of ruling almost coincided with the time of ruling of General Pinochet. The main motto of Shcherbytsky's policy was just to follow the policy from Moscow and suppress any attempts of local initiative. Not surprisingly then, that in early 1990 the number of ethnic Ukrainians holding Doctorates in Economics or History and residing in Moscow exceeded those living in Kyiv. In 1994 the Chairman of the National Bank of Ukraine admitted that if he only had in his staff half of Ukrainians working at the Central Bank of Russia he could do wonders. So, in early 1990s a weak and inert elite without clear strategic vision controlled high positions in Kyiv, while the new team took control in the post-soviet Russia: none of the USSR ministers has secured his position there. At the same time, in Ukraine the first President was one of the former leaders of the Communist Party. Two Prime Ministers, V. Fokin (1991-1992) and V. Masol (1994-1995), were the Soviet Ukraine top officials. In 1998 the former Minister of Agriculture with openly leftist views was elected as the Parliament speaker. Finally, the retired chief Prosecutor of the Soviet Ukraine was re-appointed in 1997. He occupied this position until early 2002, despite his senior age.

Another reason for certain degree of conservatism and inertia is the demographic structure of the Ukrainian population. Ukraine is the most "aged" among the FSU countries with 30 percent of pensioners in the total population. This is owed to the relatively mild climate ("Florida effect")

combined with a high degree of urbanization, low birth rates and the sticky wage policy in the USSR that forced mobile labor force to seek higher paid jobs in the North of Russia and Siberia. From the economic perspective it means the high tax and social burden; from the political perspective – the higher level of paternalism and institutional memory. Noteworthy, the “conservatism” in the post-communist world means not the lassies faire, but exactly the opposite.

We have to note that the overall tradition of statehood was clearly weak in Ukraine. As all decisions related to the USSR economy were made in Moscow, Ukraine inherited the undeveloped decision making system, with no capacity for strategic planning.¹² No consistent programs of reforms were prepared in 1989-1992 and the quality of the first programs was low. The Ukrainian nomenklatura had the fear of losing lofty rents in the fight with the Moscow nomenklatura inherited by Russia.¹³ At the time of reforms’ launching (1991-1992) many people believed in Ukraine’s economic advantages (Szporlyk, 1995) and the very success of Ukraine as an independent state was related to the perception of success in economic reforms. We agree with Szporlyk that it partly prevented the government from the risky and potentially unpopular policy moves. Moreover, trying to pacify immediate losers – former Communist Party officials, retired military and special service officers, agrarian bosses, and itself originating from the Soviet bureaucracy the first government needed support from this, the most powerful, social strata. It makes the striking contrast with the respective years in Russia. Yet, as we argue further, the main reason for postponing the reforms was the related to that risk to cease lofty rents.

External factors for a long time were also supportive to this passivity. Being highly paternalistic, the Ukrainian ruling elite has continued the SBC towards the domestic firms, and has also willingly accepted the same kind of treatment from its Big Brother – Russia and, later, from IFOs. A high percentage of Ukrainians at the top positions in Russia (e. g., a lot of governors in Russia are of the Ukrainian origin) also could partly explain why in 1992-1993 the ruling circles of Ukraine relied so heavily on their links with the counterparts from the Russian Federation. The permanent bargaining with foreign donors and creditors is the major part of Ukraine’s foreign policy, which looks similar to the well known bargaining within the soft budget

¹² This is true as well for most of the other post-communist countries, like Belarus, former Yugoslav republics, countries of Central Asia and Slovakia.

¹³ The first Ukrainian president and one of the last Communist leaders of Ukraine L. Kravchuk has made an indirect confession of that: “Yeltsyn said that he has proclaimed the policy of quick market reforms. Being asked about the recently agreed co-ordination in this issue he peremptory said “You have to follow Russia” (The Mirror Weekly, # 32 (356) August 23, 2001, <http://www.mirror.com.ua>)

constraints' based hierarchical relations. It is easy to see all components of the latter:

- the vague rules of the game (e.g., the exact amount of Ukraine's gas debt to GasProm was unclear for 1.5 years; the IMF tolerated the partial fulfillment of the memorandums);
- the key role of the interpersonal relations (the Presidents Kuchma and Yeltsyn used to solve the major problems, like debt restructuring, during informal talks);
- loyalty to the partial cession of sovereignty in exchange for a paternalistic resource supply (Ukrainian authorities tolerate the arrogant and politically incorrect speeches of Russian top officials such as Luzhkov, Chernomyrdin, etc. as well as sometimes imperative and supercilious sentences of the Western partners; the Memorandum between the Government of Ukraine and the IMF regulates, for instance, how often the sessions of the Ukrainian Currency Exchange should take place; Ukraine's President is personally involved in negotiations with the representatives of multinationals and Russia's regions, etc.).

As we will see, this similarity between the macro and micro paternalism is not just a coincidence, particularly because the "external" SBC were the source of funding of the "internal" ones, thus postponing the urgent reforms.

But the paternalism is not a problem of the ruling elite and old directors only. According to the poll conducted by the "Democratic Initiatives" foundation in 1996, 20.0 percent of respondents answered that the "economic reforms" mean the strengthening of the State's support to the weak firms, and just 5.5 percent admitted "the bankruptcy of the loss making firms". As Yakoub, Senchuk and Tkachenko (2001) have found, the expectation of state support still strongly prevails in all strata of firm management in Ukraine. Almost 74 percent of the respondents believe that the government should support them if their businesses run into troubles such as losses or lack of investments. The most surprising is that two thirds of start up businesses shares this paternalistic attitude. While 63 percent of managers actually do not expect any kind of state support and rely on themselves, another 37 percent not only consider the State support as a good thing, but are confident that they can rely on such a support. If we break down answers into three groups: a) purely paternalistic, b) purely independent and, c) those in between (having paternalistic expectations but, anyway, relying on themselves), the picture will become more telling. We see (Figure 4) that the percentage of firms with purely paternalistic attitude averages 37 percent, while another 37 percent, although being nostalgic for state support, anyway rely on themselves. The remaining 26 percent are self-sufficient and self-minded.

As expected, the purely paternalistic idea is predominantly shared by 58 percent of large-sized and 52 percent of state-owned enterprises. It received support from 40 percent of medium-sized and privatized businesses (a lot of privatized companies inherited old-style management and the respective views). The least purely paternalistic are small companies (31 percent) and start-ups (29 percent).

As soon as one of the fundamental features for creation of the market environment is the spirit of private entrepreneurship and self-sufficiency, the market's *invisible hand* should select the less paternalistic firms' leaders. In Subsections 3.4 and 5.3 we examine how strongly the respective mechanisms are in place in Ukraine. Here we just make a general conclusion that raising the new class of independent entrepreneurs and retraining of the human capital is really critical for growth of today's Ukraine.

Subsection 3.2: Overindustrialization, its institutional roots and consequences

An excessive share of industry in the GDP is usually considered as an unfavorable initial condition for transition. Just as other kinds of economic distortions it entails substantial cost for alleviation, such as costly and painful restructuring of the single-plant towns, job creation, ecological problems, etc. Also, vested interests tied to the old industry may impose even higher social cost in transition by undermining the discipline and encouragement (World Bank, 2002). We add that overindustrialization is also a manifestation of deeply inherited and potentially more dangerous institutional problems that may lead to other economic distortions in the transition.

The roots

The USSR during 1970-1990s serves as a good example in the accumulation of a negative social capital backed by the natural resource abundance. No single component of the market selection system was in place under the Soviet system. Instead, the ruling circles chose the directors not on the criteria related to the managerial abilities and firm's performance, but heavily tied to the interpersonal links within nomenklatura.¹⁴ "Economic policies" were based on the Marxism as an

¹⁴ During the last Soviet decades the tough central planning was in fact partly replaced by the pseudo market "economy of favors". This was in fact quite closed system with limited leakage of nomenklatura cadres and vague rules of the game as a tool of carrying out the informal

ideology (unlike in the CEE countries). The Marxist approach has (among many others) two shortcomings particularly important for our analysis. Firstly, this theory has ignored the problem of incentives, and considered the ROP as the only tool of economic growth. Secondly, the capital accumulation, with a stress on the heavy industry, was regarded as the only source of labor productivity growth with little attention paid to the marginal productivity decline. Consequently, the Marxists believed that while the market economy has some obvious restrictions for the rate of investment growth, the communist economy, free from these restrictions can grow faster taking advantage of the high rates of forced investments mobilized for the sake of the “bright future”.

Indeed, during 1930s – 1950s this approach seemed to be quite fruitful in delivering high rates of growth. However, the ultimate price of such a policy was really terrible.¹⁵ In 1960s the inevitable slowdown due to an inefficient economic development became obvious. The authorities reacted in their resource-oriented manner: in response to the declining efficiency they tried to force investments (Guriev and Ickes, 2000). This only worsened the situation. Such an investment can be regarded as a leakage, because it led to the deadweight losses in the long run and the adverse selection of the firms’ CEOs (Subsection 3.1). As soon as the heavy industry was the main subject of these “ideologically driven” investments, its size may serve as a proxy for the intensity of adverse selection and rent seeking.

The resource abundance played the key role in the preservation of this inefficient system. It has allowed the ex-USSR to postpone reforms for additional 20-25 years. Then, under Gorbachov, with some decline in the oil prices the former Soviet Union resorted to external borrowing for the sake of continuation of the ROP. The break-up of the Soviet Union was not accompanied by a sound rotation of elite, like it usually happens with the bankrupt firms. As a result, the respective culture of passive elites supporting loss-making enterprises that was inherited by both Ukraine and Russia led to similarities in the transition patterns observed in both countries.

property rights. Under this system the adverse selection became even stronger, since the failed manager rarely was really laid off, mostly moved onto another position of control with no guarantee for the successor to be more successful. The interpersonal hierarchical relations within the “economy of favors” rather than other abilities in fact determined a manager’s career. The result was the selection of weak and heavily dependent rather than strong managers (Winiecki, 1996).

¹⁵ About 7 million people have starved in Ukraine due to the terrible famine of 1932-1933; meanwhile the USSR continued the export of grain confiscated from the peasants in order to accumulate investment resources necessary for industrialization.

The magnitude

By the time Ukraine has restored the independence, its economy and population were the typical examples of products of the Soviet system:

- The Soviet economic system was characterized by an extensive “ratchet-based” growth that led to the remarkably inefficient resource allocation, especially in the investments (Guriev and Ickes, 2000). Being well industrialized before 1917, Ukraine became one of the most over-industrialized parts of the ex-USSR, with a more than 60 percent share of industry in GDP and the highest share of large-scale industrial enterprises within the FSU.
- The industrial sector of the ex-USSR was developed primarily in the (a) so called “basic industries”, i.e. secondary raw materials production; and (b) military industry. Both largely dominated in Ukraine. The share of the former in the total industrial output was estimated to reach 60 percent in 1990 (in the world prices). The share of the latter was estimated at 10-20 percent (Boss, 1994). 2.7 million people were employed in the 1,800 military-oriented enterprises making the relative importance of military production in Ukraine the second highest in the FSU.
- While the resource-oriented policy has led to the notorious inefficiency in the resource utilization throughout the former USSR, Ukraine was the dishonorable leader in this respect. High-energy consumption was considered as little problem in the non-market, mostly closed economy of ex-USSR notably rich in energy resources, but led to the unfavorable terms of trade in the energy scarce Ukraine. Moreover, the inevitable terms-of-trade shock, which followed the trade liberalization, was especially painful for the resource-dependent industries, which dominated in the Ukrainian economy.
- Soviet-type human capital was characterized by the huge share of professionals in science, engineering and research. In 1981-1992 Ukraine had the world's highest percentage of researchers - 6,761 per million people (World Development Report, 1997).
- Although in USSR the problem of aging was recognized just as a remote threat, for Ukraine it is as acute as for the typical Western European country. It implies high burden for the working

generation. In some regions the ratio of working people to retirees is close to one.

Consequences

Such a structure of the economy entails that Ukraine under communism has suffered from the resource oriented paternalistic policy probably more than other Soviet republics. Moreover, this structure by itself made Ukraine more vulnerable to the transition than any other country of the FSU since deindustrialization or re-industrialization meant high costs in terms of output contraction and the shedding of the labor force.¹⁶ These difficulties are even more profound due to a large military industry since its restructuring is notably costly (Gurieva and Ickes, 2000). In addition, Ukraine produced only 3 percent of the *final* arms of the ex-USSR,¹⁷ and it was the common pattern for the sophisticated manufacturing as a whole. Thus, the effect of industrial disorganization in Ukraine was really devastating. On the other hand, large distortions and inefficiency, especially combined with abundance in human capital, may imply the large potential for rapid “transition-driven” growth.

Filer, Gylfason, Jurajda and Mitchel (2000) suggest that *“Although increases in the efficiency of use of current inputs are typically seen as not relevant to long-term performance and growth prospects, we argue that such a view is an over-simplification, especially in the context of the transition from communism to market economies”*.

For such increases to be achieved: (1) substantial re-allocation of resources should take place (improvement in the “allocative efficiency”); (2) considerable changes in the management of business and government organizations should occur (improvement in the “organizational efficiency”).

¹⁶ Extending the analogy drawn by G. Ofer (2000) we may describe the process of economic development as a sort of mountain climbing as follows. All countries are going ahead having a purpose to reach the highest altitude, each one is trying to find the way that suits it better. Moreover, they may choose different peaks to climb on. These peaks are of the different heights, which can hardly be measured from the ground. So, whilst the most successful (for this moment) countries has chosen the “market economy + representative democracy” twin peak, some other groups are trying actually different hills or rocks. Particularly, the post-communist countries have climbed onto the steep but harsh rocks that seemed to be the fastest way to the heaven. They have made a significant progress at the initial stage and to some extent did catch up with the most developed countries in “altitude”, although the price of that was too high in any respect. But several years later they have approached a top and realized that it is actually much too low, and there is no straight way up. Moreover, contrary to G. Ofer’s analogy, we suggest that there is no any direct way toward the mainstream road too, since this place is not just on the different side of the same hill, but rather on the top of the different hill. Thus, before joining the main group, the post-communist countries should move downward.

¹⁷ Halchynsky, A. (1999) *Ukraine: A March to the Future*, Kyiv, Osnovy.

As soon as no mechanism of such changes was in place, this required the active creative work of the government and civic society. Moreover, due to the huge distortions inherited from the Soviet era, both kinds of changes required not only the cosmetic improvements in the existing entities and skills, such as some training of staff and minor restructuring of firms; but the full “creative destruction” mechanism to operate. This, in turn, required the creation of the competitive environment able to select really capable actors and provide them with the right incentives and technologies.

Here we must remind a few more common Soviet patterns inherited by Ukraine. The agriculture, based on the collective ownership, was wasteful and not self-sufficient, despite the remarkably good soils and a favorable climate. It constituted about one fourth of Ukraine’s total output and employment, but with the important exception of small private plots was unable to support the other sectors, as it usually happens in the less industrialized economies. The consumer goods were mostly non-competitive due to absence of marketing principles (“to produce what could be sold, not to sell what has been produced”), low quality/price ratio due to the overall inefficiency in the resource utilization, and low flexibility of production. Along with obsolete technologies, poor labor force motivation and poor design of goods these factors made the vast majority of output in the high-effort production non-competitive. Even the firms that were potentially competitive required some restructuring of the vertical links. Thus, most of the existing entities led by the incumbent executives would be expected to fail in the fair competition.¹⁸ Creation of the competitive environment should be supported with the sound institutional policy that would promote and facilitate the selection of market actors and firms’ restructuring, as it mostly happened in Central Europe and the Baltics. Such a policy was absent in Ukraine.

We argue that the most harmful institutional consequence of the overindustrialization in Ukraine was the creation of the powerful industrial lobby that, together with their agrarian colleagues, since the very beginning of transition started to extort resources from the rest of the economy. Ideologically, they have met a full support from the conservative (in the post-Soviet meaning) officials that were strongly inclined toward maintaining the volumes of production and preserving the existing entities along with existing cadres by the means of their habitual resource-oriented

¹⁸ For instance, Ukraine used to be the largest Soviet TV sets producer with total annual capacity close to 4.5 million TV sets. This was widely acknowledged as an advantage for its economy, since TV sets were in shortage in the USSR. However, these devices were made on the basis of the technology of 1970s with just 8 channels available; the average life span of a TV set was one-two years; but the retail price was as high as USD 1.000 by the official exchange rate.

policy.¹⁹ At the interpersonal level, they widely used the strong paternalistic patron-client relations that were inherited from the Soviet era and remained intact due to the lack of elite's turnover. On the other hand, after the exhausting hyperinflation in 1992-1994 no social force effectively opposed this pressure allowing for the state capture (Hellman, 1998). As a result, these lobbies together with the "de novo" rent seekers were granted with huge funds and privileges – just open subsidies accounted 60 percent of all budget expenditures in 1992, which was one of the main sources of hyperinflation. Then these open subsidies were replaced with the system of the hidden ones that account for about 20 percent of GDP (Lunina and Vincentz, 1999). The prohibitive tariffs and various trade restrictions were imposed, although partly alleviated by corruption.

As a result, Ukraine not only failed to postpone the drastic fall in GDP, but in fact experienced the third largest in the transition region economic decline – only Moldova and Georgia that went through the war conflicts experienced larger ones. The high-effort industries have fallen much deeper than the so-called "basic" ones, which preserved and expanded their share in GDP. Since the beginning of the transition the worsening of the current account balance, the substantial depreciation of the domestic currency and industrial decline became the natural consequences of the inherited structural deformations. Unfortunately, these deformations tend to persist, partly because the government's policy, at least up to the recent moment, was essentially aimed at maintaining of existing fixed assets.

Contrary to the theoretical expectations of the "end game" approach (e.g., Sachs and Pivovarsky, 1995), the maintenance of the existing capital stock and its expansion was of the major concern for the industrial lobby, perhaps, because of the privatization expectations and the well-established ways of rent extracting tied to the purchasing of the new equipment or spare parts. Here the lobbyists met the government's intellectual inertia accompanied with a natural concern about the sharp GDP decline. Due to the inherited Soviet tradition of the resource-supply-oriented response to the deterioration in efficiency, it became easy to squeeze out different open and hidden subsidies just by promising that these resources would be invested. The vast majority of these resources were spent for the maintenance of existing, often obsolete, equipment. Consequently, despite a sharp recession capital stock has grown by 10 percent since 1991, and, most of this expansion occurred in 1992-1994, the years of the severest decline and social

¹⁹ Whenever there is a talk for the necessity of more drastic and consistent reforms including bankruptcies and firms' restructuring, the typical response of the top officials is that "we do not have enough candidates to replace the incumbent directors" and "we need to secure that the new owners will not change the profile of a firm".

devastation. However, comparing to the Soviet era, the rates of capital accumulation are much lower.

The policy of preventing decapitalization by providing capital-intensive enterprises with SBC is indeed one of the main causes of deep economic decline in Ukraine in 1991-1999 (Dubrovskiy et al., 2001). It also partially explains the observed negative correlation between capital investment and growth: if new investments were primarily made depending on the existing capital stock ("on demand"), they were largely wasted, since these enterprises already had under-utilized fixed assets and, given their poor management, could barely allocate new investment efficiently.

Thus, encouraging new fixed capital accumulation makes little sense until the comprehensive system of capital reallocation is created and SBC are eliminated.

The structural distortions were caused by priority development of the military sector and machinery production, and the overvalued exchange rate. From mid-1970s domestic energy supplies were fixed at the ridiculously high level. While the cost of crude oil has almost quadrupled, the energy-consuming enterprises were indirectly subsidized. In 1990 the price of 1 ton of crude oil was equal to price of a pack of Western cigarettes. The situation when the domestic price of goods was close to 1 percent of their world price was typical before 1991. The artificially overvalued exchange rate helped to maintain the distorted structure of production.

To make things worse, production of potential high-effort exports (machinery, pharmaceuticals, apparel, and foodstuffs) took place in the autarky. It led to the low quality of goods and limited number of tradable goods. Only 14 percent of exported machinery and equipment met the world standards. During 1986-1991 the share of competitive goods fell from 65.3 percent to 26.3 percent, while the share of outdated production grew from 20 percent to 60 percent.

In 1991 Ukraine had a positive trade balance with the FSU republics, and the negative trade balance with the rest of the world. Although in 1976-1985 GDP growth averaged 3 percent, followed by a slower 1.0 percent growth in 1986-1991, the Ukrainian economy experienced a permanent shortage of goods on the domestic market, which can be explained by an excessive demand. The negative balance of payments was deepened by the increase in domestic absorption with the help of expansionary monetary policy. Obviously, 390 percent of inflation in 1991 did not eliminate the "monetary cap".

Because of artificially undervalued prices on energy supplies Ukraine inherited extremely energy-consuming enterprises. In 1991 Ukraine's energy expenditures per 1 unit of GDP exceeded the Korean indicator 8-

fold, and the Chilean more than 6 times. Energy efficiency in Poland, the Czech Republic and Hungary was 26 percent, 40 percent, and 55 percent higher, respectively. To summarize, at the beginning of transition the unprepared management of the Ukrainian enterprises faced a difficult choice between the full closure and radical restructuring.

The inheritance of the industrial sector, non-competitive on the world market, makes Ukraine's economy similar to economies of Latin America in 1960-1970s, where the long-lasting experimenting with the policy of import substitution caused inefficient resource allocation, stagnation of exports of manufacturing goods, agricultural decline, acceleration of inflation and chronic problems with balance of payments. An increase of output did not improve the current account balance. On the contrary, rising imports of raw materials and equipment worsened the trade balance. The direct reason for structural distortions was the conduct of the expansionary economic policy with the emphasis on comprehensive government interference in the economy. Latin American countries widely used such policies as an increase of budget deficit, subsidizing of loans of commercial banks, trade protectionism, administrative price and wage regulation.

In order to achieve macroeconomic stabilization Ukraine, as well as Latin America, financed the deficit of balance of payments through domestic and external borrowing. However, the use of these loans served merely as a substitute for structural changes.

Subsection 3.3: Rents and distortions

The initial structure of the Ukrainian economy reflected the price distortions caused by the Soviet central planning. After the price and trade liberalization the adjustment to the new reality was expected. This adjustment, first of all, should have meant a reduction in energy intensity, as it has happened around the world in 1970s. But from the macro perspective the economic processes in Ukraine in 1991-1998 (August) resembled those typical for the resource-abundant country experiencing the Dutch disease:

- ✓ Exports were growing, at least over the first transition years.
- ✓ Energy intensive products were the major export commodities and totaled 66.2 percent of merchandise exports; chemicals (mostly the nitrogen fertilizers produced from the air and natural gas) constituted 12.3 percent of Ukrainian exports in 2000.²⁰

²⁰ Ukrainian Economic Trends, June 2001.

- ✓ During 1992-1998 a sharp growth of the share of raw materials in both GDP and export was observed. While GDP fell by 60 percent since 1991 the consumption of natural gas went down by just 35 percent. So, the share of energy consumption in GDP over the 1990s **increased** several times rather than decreased.²¹
- ✓ Ukraine remains the most energy-intensive European country. In 1997 per 1 kg of oil equivalent Ukraine produced just 1.1 USD on a PPP basis, while Saudi Arabia USD 2.1, Poland USD 2.7, Mexico USD 5.1, Brazil 6.5, Argentina USD 6.9 (World Development Report, 2000/2001). The share of energy consumption in Ukraine's output reaches 25 percent, which is 4 and 8.3 times as high as in USA and France, respectively. Ukraine uses 1.81 kg of the conditional fuel per 1 USD of GDP, while this indicator for the EU is just 0.2 kg.
- ✓ since the lowering of inflation, appreciation of the real exchange rate was observed.
- ✓ Economic passivity (reluctance to reforms) clearly takes place: Ukraine is regarded as a lagging reformer by the EBRD indexes (Table 2). Investment and education expenses are declining.

Only the current account deficit financed by the rising external debt and decreasing real incomes of population (as a result of wage and pension arrears) did not fit the description of the well-known Dutch disease. But actually Ukraine is not well endowed with energy resources! On the contrary, Ukraine is a net importer of energy, which constitutes 43 percent of her merchandise imports. In 2000 the value of the imported fuel and energy was USD 5.9 billion, or 18.6 percent of GDP. In other words, for 1 dollar of GDP Ukraine had to import fuel and energy worth USD 0.186. The Ministry of Economy of Ukraine indicates that the share of imported inputs in the Ukrainian exports is close to 40 percent, making the country's external position extremely vulnerable to the price shocks.

How can we explain the fact that the symptoms of the Dutch disease are observed in the energy-scarce Ukraine? Definitely, for these symptoms to occur in Ukraine there should be some mechanisms for generating macro rents. We describe these mechanisms below.

In 1992-1993 the energy supplies from Russia at far below the world prices was a significant basis for generating macro (and micro) rents. The re-export of this energy either directly or in the form of energy-intensive commodities brought to Ukraine some USD 4-5 billion annually as a re-

²¹ Kaufmann and Kaliberda (1995) misinterpreted it as the effect of the shadow sector's growth.

distributional macro rent. This source of cheap energy ceased in 1994 when Russia increased prices on the exported energy supplies. In the Baltic and CEE countries this price shock has happened earlier and resulted in the sharp fall in the production and exports of energy extensive commodities, as well as in the drastic reduction of subsidies, fiscal stabilization, etc. This sort of adjustment, however, did not take place in Ukraine. Because the Ukrainian ruling circles were energy-addicted, this “true” source of rent has been replaced by the “virtual” one – the payments for gas were almost stopped. This debt was soon taken over by the government. As a result, the external debt started to increase by approximately USD 2 billion annually. In 1994-1995, it was mostly the bi-national debt to Russia and the loans from IFOs.

Instead of austerity measures aimed at cutting the budget deficit, the authorities have launched, allegedly for the sake of macroeconomic stabilization (non-emission financing of budget deficit), the T-bills market in 1995 and later placed the Eurobonds. The interest rates on both types of financial instrument were exorbitant and, ultimately, unsustainable.

We argue that the issue of T-bills and external borrowing was nothing else but a very special mechanism of generating virtual macro rents, which were converted into the micro ones both through the direct participation of privileged participants in enormous yields, and the postponement of structural reforms.

Examining the history of the Ukrainian T-bills market, we see that its operation resembled a sophisticated version of the Ponzi game, where the first players (winners) took all (as the annual real yields on the first T-bills exceeded 100 percent) and the last ones were simply losers (as a result of default). There is some evidence that participation in the T-bills market was not open for everybody (for instance, the foreign investors) since the very beginning.

The government policy of financing the budget deficit (largely generated by budget subsidies and tax exemptions) through the proceeds from the T-bills sales and Ukrainian Eurobonds' placements was extremely costly and detrimental for the economy. The reluctance to reforms clearly took place. During 1994-1998 neither guaranteed credit lines, nor restructuring of indebtedness to Russia and Turkmenistan, nor loans from the international financial organizations were used to finance the expenses related to the radical structural changes.²² Actually, the use of domestic borrowing (via T-bills) and foreign loans has served as substitution for structural changes. At a cost of borrowing through the T-bills market approaching 40 percent at the beginning of 1998 the servicing of rapidly growing debts was clearly

²² Just a marginal progress in the corresponding indicators occurred for this time (World Bank, 2002).

problematic (Ivaschenko, 1998). At the same time, the revenues from the placement of Ukrainian Eurobonds in 1998 were used in the following manner: 55 percent for reducing wage and pension arrears; 30 percent for servicing of the external debt; 15 percent for servicing of the domestic debts (T-bills market). In short, it was a game of paying debts at the expense of accumulating even higher debts. Clearly, it was a policy leading to nowhere else but to the financial crisis of 1998.

To complete the picture of the sources of macro rents in Ukraine we add two more points. First, the revenues from fees for gas and oil transit through the Ukrainian territory totaling USD 1.6-2 billion annually represent a substantial source of macro rent for the country. Second, as far as the gas trading with Russia and Turkmenistan is accomplished in non-monetary means of payments, it remains a sort of import rents, although the significance of this rent is shrinking since suppliers increasingly demand payments in the monetary form. Until now authorities had a chance to get rents from opacity of payments for gas. Ukraine also drills her own oil and gas, which generate some macro rent.

Generally speaking, a macro rent is not a doom as soon as the institutionally strong and competent government can channel it for the benefit of the whole nation, and hence to prevent its conversion into the micro rent. Unfortunately, Ukraine did not succeed in doing so. In Russia the virtual economy as well as export restrictions and administrative pricing for energy supplies help to share the macro rent among the customers, but without any credible commitment for the future liberalization it is just another form of the ROP. Ukraine, at least before the 1998, used to do the same with domestically drilled oil and gas. However, the major source of macro rents, the transportation of gas is beyond the control of tax authorities. While planned tax revenues from this source totaled USD 391 million (the potential volume of revenues should be 4 times higher) in 1999, just 8.5 percent of this were received. In 2000 the respective tax revenues tripled, but still remained ridiculously low (Section 5). The rest of funds seem to have ended up in private pockets.

Micro level

In the market economy the macro shocks transform into the respective incentives at the micro level that finally produce the economy's adjustment. The mechanism that, at the micro level, should force the adjustment of the sector structure of the Ukrainian economy to the price shock of trade liberalization would look as follows.

The new political reality has determined unfavorable terms of trade for the producers of energy intensive commodities. For a Ukrainian firm that

produces tradable bulk commodities like metals or chemicals, the market for its output is typically subject to nearly perfect competition or, in the best case, oligopoly. It is usually highly volatile with large-scale speculations, price shocks, anti-dumping sanctions, etc., and the Ukrainian firm usually finds itself as a price taker. On the other hand, its inputs are the raw materials supplied at the monopoly or oligopoly conditions by Russian companies like GasProm, Lukoil, etc. It makes the respective Ukrainian manufacturers to be severely affected by increasing energy prices. Thus, Ukraine's comparative advantages in the production of the energy-intensive commodities are limited. Without a sound State's support, the energy-intensive enterprises are expected to be either bought by their Russian suppliers, or doomed to decline or decapitalization, as it happened in the Baltic states.²³ Neither of these has happened in Ukraine yet.

Why despite the sharp price shocks in 1992-1994 energy intensity has been not falling, but rising up to the year 2000?

The survival of the energy-intensive enterprises and continuation of the ROP in Ukraine is clearly related to the possibility of generating micro rents (at the expense of wasting macro rents).

The practice of buying cheap (due to price regulations) metals and chemicals and selling them abroad at the world market prices played a key role in the creation of well-connected (as this required access to metals and export permits) fortunes. It is estimated that in 1992 alone the total export rents amounted to USD 4.1 billion, or 20 percent of GDP, as domestic prices were ten times lower than the market ones (Economic Reform..., 2000).

The import of oil and natural gas from Russia and Turkmenistan, often at below the world market prices, and a subsequent exports of these commodities to the West at higher prices was a simple, but a very effective mechanism for the oligarchs to accumulate huge rents. As import contracts were backed by the government guarantees, this mechanism provided an excellent opportunity to create enormous private wealth at the expense of the budget deficit. According to some estimates, in 1992-1999 some USD 25-40 billion (generated through imports-exports and other types of rents) flew outside of Ukraine through the use of fake companies and contracts (OAB, 09/05/2001). **Seventy nine (!)** percent of payments for energy imports are still (in 2001) made through the offshore zones.

²³ Indeed, it would be followed by job destruction. Here a government should do its best to alleviate the social consequences of such a shock, primarily by facilitating the market-driven job creation in other sectors.

Having this money, the united lobby of energy intensive sectors contributed to freezing of status quo priorities in the economic policy, which totally ignored the terms of trade and potential comparative advantages of Ukraine for the sake of support of these sectors, or, to be correct, existing sources of rents.

It would be the brightest example of state capture (Hellman, Jones, and Kauffman, 2000) if the government had been initially inclined toward the positive direction and then, being corrupted by the oligarchs, has changed its mind. But in Ukraine the government seems to have been captured by vested interests from the very beginning. It supported the energy-intensive entities by all possible means and, thus, the ROP and inertia prevailed.

We suggest a set of micro level institutional explanations why the energy intensive sectors survived and flourished:

- The absence of marketing was one of the most notorious shortcomings of a central planning. However, the production and sales of bulk commodities require minimal marketing efforts, because the information asymmetry between a seller and a buyer is minimized;
- These commodities are easy to barter with, and stock quantities can be easily falsified; on the other hand, their production, being less sensitive to a rise in transaction costs, is perfect for the “virtual economy”,
- Due to the economy of scale, (a) a number of market participants is limited and rent is easier to distribute among firm directors and bureaucrats; and (b) large enterprises serve as the basis for local communities, giving directors an opportunity to blackmail the authorities.

The long-term perspectives of the energy intensive sectors, however, are quite questionable. Their revenues do not directly stem from mineral reserves, but are derived from (1) the forceful resource redistribution from the other parts of the economy, and (2) irreversible depreciation of the fixed assets of enterprises. The first reason makes them highly dependent on the authorities. Their equipment is dramatically worn and need to be upgraded, which requires investments. However, the poor protection of property rights keeps the investment risk in Ukraine high. Hence, the hopes that the Western funds will flow into these sectors are thin.

So, these companies work as a “rent pump” rather than a producer of goods, similarly to the mechanism described in a model by Lambert-Mogiliansky, Sonin, and Zhuravskaya (2000). But is it really the effect of

the deliberate government policy, or mostly the result of the inherited from the Soviet era distortions?

We have performed an extensive analysis of the Ukrainian legislation acts issued by the Parliament (Verkhovna Rada), the Cabinet of Ministers, and the Presidential Administration during 1992-2000. In the legislation database kindly provided by LIGA Co. we have found around 10,000 legislative documents related to the business activities in the sector of commodity production.²⁴ Among those legislative acts, 2,232 appeared to be related to the energy resource consumption. This indicates that energy-related issues were of primary focus for the authorities: on average, every working day they have issued a legislative document devoted to this problem.

We have estimated the number of legislative documents devoted to three energy-related issues: a) the encouragement of energy consumption – an indicator of the ROP in its worst form; b) facilitation of energy savings, c) the market-oriented policy of hardening budget constraints and leveling the playing field. We have also tried to track the changes in the prevailing means of the ROP during this period of time. Certainly, a single regulation may be worth a thousand others. However, here we measured not the effect of these regulations, but a government's activity in the energy-related field.

The results of our analysis are presented in Figure 6. More than 1,000 of all legislative documents concerning energy issues bring the signs of soft budget constraints. At the same time, just 230 of them can be qualified as hardening the discipline, of which 94 were adopted in 1999-2000. Another 356 are devoted to the resource-oriented but often not supported with funds attempts to facilitate energy saving. Thus, there is clear evidence that the deliberate ROP strongly prevailed in 1992-1998. Later we discuss in details the further developments that took place in 1999-2000.

During the first period (1992-1994) virtually all rent-seeking instruments that were used relied on the cheap or even free (written-off later) credits, as well as direct budget subsidies. Later, when macroeconomic stabilization was introduced, these instruments were partly given up (making Western donors happy), but instead replaced with barter, mutual offsets, promissory notes and other more sophisticated means of the ROP. All these instruments of support were, of course, implemented at the expense of the budget. On the one hand, it caused the high rate of taxation for the non-privileged sector of economy. On the other hand, while the official fiscal deficit was formally reduced to the IMF required 3-5 percent, the true one (i.e., accounting for arrears) actually was never below the two-digit level.

²⁴ The detailed description of the used methodology is available on request from the authors.

So, actually all these rents, including the “virtual” ones, have flown to the elite’s pockets through the rent pump of energy intensive sectors, leaving to the nation a liability to pay them back with interest.

We can provide just a couple of indirect evidences for the symbiosis of parasites that made the rent pump work, since just a few episodes of corruption were investigated. After the mid-1994, when the “first-rank” old nomenklatura was partly replaced with the “second-rank” one, the representatives of energy-intensive industries occupied the key positions in the executive hierarchy for the whole period between 1995 and mid - 1999.²⁵ Then, a special position of the Vice Prime Minister on energy issues was introduced. In February 2001, it was replaced by the position of the First Vice Prime Minister on industrial policy that is now occupied by the former steel mill’s director. Although, unlike his predecessors, he is not associated with the corruption deals (at least for this moment) and known as an honest and successful manager, it is hard to imagine him sanctioning the elimination of the current privileges to metallurgy.

The overall inclination toward the energy-intensive production remains. In 2000 the Mykolaiv alumina plant was privatized with the requirement for the winner to build the aluminum plant in Ukraine in order to provide the country with “independence” in this necessary for the aircraft industry commodity. But aluminum is the typical tradable and can be easily purchased elsewhere; at the same time the aluminum melting is one of the most energy intensive and ecologically harmful works. For these reasons the respective Russian enterprises are located near the sources of cheap hydro energy far in Siberia. If this plant is built as expected it would bring more headaches than gains to the Ukrainian economy.

Thus, the institutions and links created in the process of gaining and distributing macro rents at the initial stage of transition were then used for establishing the system of rent seeking that operated through the distribution of the value created by other parts of the economy and the creation of the “virtual” rents.

²⁵ Pavlo Lazarenko, who is now in the U.S. custody for the money laundering (figures vary from USD 200 million to USD 5 billion), was the First Vice-Prime Minister in 1995-1996 and the Prime Minister in 1996-1997. He has been evidently tied to UES Corp., the gas supplier with approximately USD10 billion annual turnover, which controlled more than a half of the Ukrainian natural gas market. This is the brightest but not the only example. We just may not name the numerous other top officials associated with various business groups operating in the energy-related business, since, unlike Lazarenko, they are not officially accused or convicted. But the results of our legislation analysis convince that their work was pretty “fruitful”.

Deadweight loss

As we have found, the government of Ukraine has continued the ROP lacking the resources to support it. The fact that more than 50 percent of the current meters and systems of measuring are obsolete is very pronounced. This policy has preserved low incentives for the energy saving, and the wastes not decreased, but increased. While the European rate of losses of electricity varies from 6 to 8 percent, in Ukraine it exceeds 40 percent in some regions (Shulha, 2001). Now the planned annual energy losses total 44 billion kWh (Electricity, 2000):

- Due to transportation costs and stealing of electricity 30 billion kWh;
- Due to ecological consumption of electricity 10.5 billion kWh;
- Subsidies to population and producers 4.3 billion kWh.

Thus, more than 40 billion kWh out of the annual consumption are spent irrationally. The loss coefficient equals 22.2 percent. The money value of the annual wasted energy totals USD 1.2 billion (3.8 percent of GDP). This amount exceeds all technical aid and IFOs loans that Ukrainian government gets annually.

Other sources of rents

If the rent seeking is restricted within one single, even large, sector, it seems to be less harmful for the economy as a whole, assuming, of course, that this sector has no monopoly power (as the energy sector does) to impose the burden onto the rest of the economy. But even in such a bad case, although the resource base for other industries may be lower, the incentives and selection of actors remain undamaged allowing these sectors to develop.

Unfortunately, in Ukraine the energy-intensive sectors were the main, but not the only beneficiaries of rent seeking. As in many other countries, agriculture is a traditional beneficiary of subsidies. Huge rents were acquired in the financial sector, arms sales, not to mention such purely criminal activities as people trafficking.

The preferential access to cheap credits represents a substantial source of rents for "selected" groups. In 1993, when Ukraine experienced 10,155 percent inflation, huge state credits were issued at 20 percent interest rate. Net credit expansion to enterprises reached 47 percent of GDP in 1993 (Economic Reform..., 2000). These credits were nothing else but the outright gifts to the well-connected people. Another common way of getting cheap credits from the former state-owned banks was to share 5-10 percent of the credit in cash as a gratuity for the decision to issue a credit. Even if such credits were issued at the market rate, they were cheap for

their recipients because they often were not repaid. But this practice was mostly stopped in 1994-1995 with just some remnants remaining. For instance, the agricultural bank "Ukraina" was under a permanent government pressure to provide credits to the insolvent collective farms, which led to its bankruptcy. Another reason for bankruptcy was soft and privileged crediting of the firms connected to some high-ranked officials. The bad loans to the tune of USD 155 million were made under the cover of the State's program of support for domestic producers. However, even now the political pressure for the widespread soft or privileged crediting remains very strong.

Budget subsidies to the state-owned enterprises in agriculture and energy sectors played a prominent role in creating fortunes and disincentives for the restructuring of loss-making firms. Only direct subsidies for energy sources, mostly coal and fuel for agriculture, accounted for more than a billion dollars in 1998 and seem to be one of the major instruments for gaining the concentrated rents. Although the share of direct budget subsidies in GDP declined from 9-11 percent in 1992-1993 to 4-6 percent in 1995-1998 under the pressure to curb inflation, direct subsidies were often replaced by other means of support of the privileged enterprises such as soft taxation and forced trade crediting that are to be discussed later in this book.

Tax privileges are important sources of rents for clans. For example, the gas trading company United Energy Systems (UES) had a turnover of several billion dollars in 1996, but it paid in taxes less than USD 6,000 (OAB, 09/05/2001).

Although the most of these rents were addresses to the energy-intensive sectors, they inevitably became dispersed among various other firms. The positive development is the clear tendency for contracting the availability of rents, at least those not related to the energy intensive industries and some privileged parts of engineering, agriculture, financial sector and trade. Noteworthy, the rents in these sectors were contracting as well.

This step-by-step limitation of rents yields the fruits. Section 5 shows that the sectors that have been privatized, and thus deprived of the state "care" are now growing quite fast.

Subsection 3.4: Barriers for local and foreign entrepreneurs to do business in Ukraine

The rent seeking of the described sort obscures the competitive selection in two ways. As admitted in the (World Bank, 2002), lack of discipline in the "old" sector not only inhibits the market exit of the less efficient, but also

brings the discouragement of the market entry, hence suppress the “new” sector. Local and foreign companies doing business in Ukraine are subject to numerous obstacles. Using data from the IFC survey of 2,153 Ukrainian firms conducted in 2000 (Yakoub, Senchuk and Tkachenko, 2001) we discuss the importance of different factors in affecting business environment in Ukraine.

We first present the results of how businessmen rank numerous factors in terms of their perceived influence on business development (Table 6). We then seek to answer another important question, which is: Are firms affected by different factors in the same way, or the influences of various forces are “selective”? The answer to this question is of crucial importance for gaining a deeper understanding of how different forces are shaping the business conditions in Ukraine. To get this answer, we perform probit regressions where probability of reporting that a given factor represents a substantial obstacle for business development is a dependent variable, and a firm’s type of ownership, size, age (number of years in business), sector and regional location are explanatory variables. We also assess the impact of the various components of the business environment on the market selection of businesses. For this purpose we examine the effect of the business culture in terms of paternalism, business planning, marketing, and social responsibility on the firms’ assessment of the regulatory environment. The results of these regressions are reported in Tables 7 and 8.

Taxation is clearly ranked as #1 obstacle for business development in Ukraine. The mean score for this factor is 3.1, which suggests it to be a very significant impediment. Within the issue of taxation the *instability* of tax legislation is reported to be a major problem (Yakoub, Senchuk and Tkachenko, 2001).

The current Ukrainian tax system consists of numerous laws and regulatory acts, some of them inconsistent with one another. Securing VAT refunds is a recurring problem for companies, and these difficulties act as a deterrent to investment. Companies having local sales can offset their purchase VAT against their sales VAT. Exporting companies often have little or no sales VAT, as export sales are zero-rated. Both permanent instability of legislation and high nominal tax rates seem to be the tools of the economy of favors. This combined with low transparency helps to create the information asymmetry between bureaucracy and the rest of population. On the other hand, high tax rates that firms cannot sustain result in the low effective rates, since firms try to defend their businesses. None of the firms that have answered the question concerning the volume of sales concealed from taxation responded that there was no concealing at all. On average, 16 percent of sales were concealed, while the average tax burden was

estimated at 53 percent of the value added. While evading taxes these firms evidently violate the law. Then they become susceptible to the discretionary law enforcement, which strengthens the power of bureaucracy. But if the competitors save on taxes by concealing some sales from taxation, a firm has a little choice, and the whole economy finds itself in the bad equilibrium in terms of a Prisoner's dilemma, as illustrated in Subsection 4.3.

The regression analysis suggests that small firms are 4.8 percent less likely to perceive taxation issues to be a problem than large firms (Column 5, Table 7). We suggest two possible explanations for this result: 1) small firms may find it easier to conceal profits; 2) taxation issue is less significant for small firms due to a possibility to use a system of simplified taxation. Interestingly, we find that, controlling for size, privatized companies are more likely to report taxation to be a problem than state enterprises. Probably it is because privatized companies are no longer subject to favors in the form of tax arrears and exemptions from the state, while they still cannot operate (or avoid taxes) as efficiently as start-ups (which are less likely to report taxation to be a problem) do. These findings are in line with the results of the Harvard Ukraine project and Kyiv Consulting group (Dubrovskiy et al., 2001) that have found tax arrears to be strikingly higher for the state firms.

Interestingly, and somewhat surprisingly, the problem of "low demand" ranks as the second one after taxation impediment to business development. However, it immediately becomes clear why it is the case when we look at the regression results. The probit estimates indicate that municipal and privatized enterprises are respectively 16.3 percent and 12.9 percent more likely to report "low demand" to be a significant obstacle than state-owned firms (which, probably, do not care as soon as SBC are in place). We view these results as indicating inability of the management of privatized and municipal firms to find markets for their products and a difficulty for these firms to compete with newly created private firms and joint ventures. A high rank of the "low demand" factor should not, however, be taken *only* as a sign of inefficiency of privatized and municipal firms. We believe that it also indicates the presence of tough competition in the market and a substantial potential for growth even in the present environment by boosting the internal demand alone.

Macroeconomic instability also seems to have a strong adverse effect on business operations. Inflation and currency exchange rate fluctuations were ranked respectively as 3-rd and 4-th among the impediments to business development (Table 6). Highly volatile macroeconomic environment makes it difficult for firms to plan the real value of their costs and revenues. The regression results indicate that inflation affects business

activity irrespectively of firm's size and form of ownership, while exchange rate volatility seem to "favor" more joint ventures and privatized firms.

Non-level playing field is ranked 5-th among the obstacles to doing business in Ukraine (Table 6). The regression results suggest that it is small companies that are most probably to be affected by unfair rules of game (Column 9, Table 7). This result indicates that there might be significant economies of scale in getting favors, with larger enterprises having more readily available resources to bid for a preferential treatment. Considering that small business is a most dynamic sector of the economy in market-oriented systems, our finding that small firms are more likely to be a subject of unfair competition in Ukraine raises concerns.

Corruption at state and local levels, ranked respectively 6-th and 7-th (Columns 10 and 11, Table 7), do not appear as *the most* significant obstacle to business. However, the fact that 40 percent of the respondents view corruption as adversely affecting their businesses, speaks for itself. The regression results clearly suggest that it is small firms, and, controlling for size, privatized firms and start-ups that experience the highest burden of corruption. Small firms are 16.6 percent more likely to report corruption to be a significant problem than large firms, while privatized companies and start-ups are respectively 14.9 percent and 11.8 percent more likely to perceive corruption as a significant burden than state-run firms. This is a clear indication that institutional environment in Ukraine is not very supportive to small and private sectors development. It is interesting to note that while importers are more likely to be affected by corruption at the local level (bribes to customs officials), exporters are more likely to be a subject to corruption on the state level (bribes to ministerial officials to receive export licenses, etc).

Tax and other inspections are a familiar frustration for business operation as they result in the "time tax" and the "bribe tax" on enterprises (Hellman and Schankermann, 2000). They are usually unannounced and require the full time attention of the main accounting office and financial resources to please the inspectors. The customs clearance is performed in four stages by three customs inspectors from different departments. Not surprisingly, custom related issues were ranked as the top impediment for foreign trade, followed closely by certification (Yakoub, Senchuk and Tkachenko, 2001).

The latter deserves a special consideration. Total standardization was one of the sources of the inflexibility of the Soviet manufacturing. It is noteworthy that by the Soviet law, any kind of goods was subject to detailed standardization, which by itself could make impossible any competition between producers. Later, in 1997-1999, being driven not by the consumers' lobby but by the lobby of authoritarian national producers, this system was recovered as a powerful tool for anti-competitive policy,

especially trade protectionism, and a source of rents. The need for Western manufacturers and suppliers in Ukraine to establish conformity with mainly Soviet-era standards drives up costs without any corresponding benefits in terms of efficiency. Producers are also required to certify both imported raw materials and finished products, which is an unnecessary duplication. At the same time exporters have to certify their products abroad, since many of the Ukrainian standards differ from ISO standards.

Investment projects involving construction require a huge number of permissions. Getting a land can be particularly cumbersome and complicated. Businessmen report that for the opening of a new gas station one needs up to 300 separate permissions, and of a supermarket around 150. The planning stage for investments of this kind can take three times as long as it does in Poland or Hungary. The process is contingent to a large degree on the attitude of the local officials, and is open to abuse and rent seeking.

Regulation (intervention) from local and central state authorities is reported to represent an obstacle for business operation by 35 percent of the respondents (Table 7). Similarly to the effect of corruption it is privatized firms and start-ups that are found to be most likely hurt by government regulations (Column 7, Table 8). This is not surprising, though, as we may expect a close correlation between the degree of regulation and the extent of proliferation of corruption practices.

Although pressures from criminal elements and local state authorities have the lowest rankings among the impediments to business development, the regression results suggest that these factors are very “selective” as they target mostly small firms. We find that small firms are 8 percent more likely to report problems related to pressure from criminal elements than state firms.

Interestingly, we do not find the issue of getting external financing to represent a substantial problem to the firms. Only 23 percent of the firms report this factor to be a substantial obstacle. The regression results indicate, though, that younger firms are a bit more likely to experience problems with external funding. This is to be expected since older firms have a more extensive credit history (or at least a history of operating in the market). It goes in line with Johnson, McMillan and Woodruff (2001) who have established that in Ukraine, as well as in Russia, problems related to the property rights are much more significant for the firm’s financing than the ones related to the sources of funding.

We have also estimated the impact of the firm’s business culture on its assessment of the regulatory environment. We first have built the following set of indicators based on the responses from the IFC survey:

Paternalism. Firms' CEOs were asked whether they agree with the following statements:

(1) "The State should support my company if it runs into troubles (loss making, lack of investment funds, etc.)", and (2) "We should rely on ourselves, not on the state support". Those firms that have given negative answers in both cases were omitted as having responded inconsistently (44 cases). Others were ranked from 1 to 3 in accordance to their paternalistic attitude:

- 1 – a firm by no means expect State's support;
- 2 – it expects a support but does not rely on it;
- 3 – it relies on the State's support.

Marketing. Firms that responded to perform a marketing research while preparing their business plans were ranked 1; others (including those who have not answered) – 0.

Business planning. – the same approach as above.

Social responsibility. Firms were asked: "What percentage of your earnings can you sustain to pay as taxes?" (answers were ranked as 0-30 percent).²⁶ We used the answers as a proxy for the businesses' social responsibility: obviously, the optimal tax rate for a business per se is zero, and the deviations can be regarded as reflecting a social concern. At the same time it partly reflects an overall viability of a firm.

Having Arrears is the subjective indicator for severity of tax indebtedness. This indicator is ranked on a 4-point scale from 1 (no arrears) to 4 (hopeless arrears).

Exports are the ranked percentage of exports in output; Imports are defined similarly.

The regression results are shown in Table 8. Generally, the stronger firms turn to be less sensitive to most of the obstacles. Controlling for other factors, smaller firms are found to be more vulnerable to the pressure from criminals and local authorities, as well as corruption. We note that all kinds of impediments are less substantial for (even partly) state-owned firms, although the state ownership dummy is not always significant.

Some other results seem to be less obvious or even puzzling at a first sight, but still can be explained. While CEOs of the Ukrainian firms are

²⁶ This formulation suffers from the bias due to the actual difference between value added (VA) and revenues. Unfortunately, in Ukraine until recently the value added accounting was not required by the accounting standards and hence was rarely done. It reflects the fact that under the planned economy the main performance indicator was not the value added, but the output regardless of its cost.

used to complain about the low domestic demand, “low demand” appeared to be rather a problem for exporters, who also responded to suffer more (not surprisingly) than other firms from excessive regulation, but not from the macroeconomic problems. Importers suffer from the corruption at the local level. The firms having business plans are significantly more sensitive to corruption (at the state level) and unfair competition. This effect, though, can be driven by the fact that the presence of the business plan serves as a proxy of efficiency (profitability).

Two more results, however, need a special attention. First, those firms that have business plans more often complain about the difficulties with securing external financing. At the same time, those firms that have arrears express the same concerns. In our opinion, these results are not contradictory if we consider the little role of the external financing in Ukraine. For instance, even among the large and medium industrial firms (excluding energy sector) that reported to have made some investments in 2000, just 29 out of 264 firms used any external financing. Thus, those firms that intend to apply for some external financing (and invest into the business plan for this purpose) are concerned about the lack of funding, while others merely do not care. On the other hand, those firms that have arrears, perhaps, regret on the lack of soft crediting.

Importantly, the less paternalistic firms do not seem to be adversely affected by any specific obstacle except criminal pressure. We may propose two hypotheses to explain why less paternalistic firms experience higher criminal pressure. (1) The firms with stronger ties to the State have better protection from the law enforcement bodies.²⁷ (2) Almost all firms have to deal with some wing of mafia – either State or criminal. It is an important part of the paternalism. Since mafia is very paternalistic by its structure and style, the more paternalistic a firm is, the more comfortable it feels being tied to mafia. Thus, if this hypothesis will be proved, the link between criminalization and paternalism will be established. We also may conclude that although the pressure of criminals is ranked as the least significant impediment among the set of obstacles considered above, it is an important factor in the selection of entities with the market business culture.

The socially responsible firms that agree to pay higher taxes are either strongly oppressed by the authorities, especially the local ones, or are more sensitive to it. This fact suggests that improvements in the business regulation may help to increase the budget revenues (Subsection 5.2).

²⁷ This does not mean, however, that they are under the lower pressure overall – as soon as the law enforcement bodies are corrupted, the firms just have another mafia's protection which may be not less costly.

Yet we should mention that these regression results have to be treated with caution, as there may be a number of factors that influence both business culture and the assessment of the regulatory environment.

To summarize our main findings, there is a clear indication that, although macroeconomic stability matters for business environment, the key impediments to business development in Ukraine have to be found on the institutional level. Unbearably high tax rates and instability of tax legislation, corruption at the local and state levels, high degree of state authorities' intervention in the operation of private firms, non-level playing field for small firms, contradictory regulation (in the areas of taxation, registration, licensing, standards and certification, and sanitary controls), economy of favors and rent-seeking represent strong obstacles for doing business in Ukraine.

Our results suggest that institutional measures such as a regulatory reform (and a tax reform in the first place) is a key priority for improving Ukraine's business environment and boosting economic growth.

Section 4:

The patterns of Ukraine's transition: empirical facts and evidences

As we have seen above, due to certain institutional peculiarities in Ukraine the role of the government as an instrument of rent seeking for state officials and economic actors is very high. The major economic actors, at least over the 1992-1999, were interested in the strengthening of the grabbing capacity. That manifested itself in the pervasive administrative intervention and the power of non-restrained bureaucracy. The government acts not as a referee paying attention to the fair rules of the game and the "fair" play, but as a major player on this field. It by no means can be considered as a benevolent one. The Ukrainian government has really strong links with directors of state-owned enterprises, which call themselves "industrialists" contrary to the new and small businesses, who are the "entrepreneurs". President Kuchma, the ex-director of the Pivdenmash Missile Plant at Dnipropetrovsk, has won the elections in 1994 as the president of the Ukrainian League of Industrialists and Entrepreneurs (ULIE) under the slogan "If Kuchma will win, your plant will be working". Fortunately, he did not fulfill this commitment completely. Now his successor at the ULIE Anatoly Kinakh is the incumbent Prime Minister. In Russia the corresponding association is politically weak and one can hardly imagine the head of the Russian League of Industrialists and Entrepreneurs at the position of the Russian Prime Minister.

These ties partly determine the inclination toward the ROP conducted by the government despite the economic reasoning. Not less important is that the paternalistic attitude is supported by substantial part of the population. With the public tolerance the predatory bureaucracy widely uses its power to extract administrative rents. Finally, the crony ties with old directors help state officials in extracting these rents. Together these factors determine the rate of Shumpeterian "creative destruction" that is low relatively to the shocks and challenges the Ukrainian economy faces. As soon as the visible process of destruction (bankruptcies, first of all) really takes place, the suppressing of symptoms cannot cure the disease. On the contrary, it only makes it worse. This results in the increasing unemployment that is partly hidden due to the high barriers for firing the workers (a firm has to pay a two-month average salary, so it prefers just to stop paying and allow the workers to leave voluntarily) and the fact that many do not register as unemployed due to the low unemployment benefits. The

most dynamic and qualified labor force leaves for better jobs either abroad or in the unofficial sector.

Subsection 4.1: Administrative intervention

Corruption is one of the main obstacles discouraging businesses. In private talks, managers doing business in Ukraine regularly cite the intriguing figure of "15 percent". So, energy generating companies plan that, at least, 15 percent of electricity would be lost. Business developers acknowledge that for the timely processing of their plans for construction this is the "normal" rate of illegal payment to city officials. Certainly, such a practice depresses the market of construction.

Another example is related to the transportation sector. In early 2000, before the new management of the Ukrainian railroads was appointed, the sector was heavily indebted. However, after the cancellation of the shadow schemes (reduction of the number of intermediaries from 600 to 12, introduction of a ban on the non-monetary forms of payments, etc.), for the first time since 1991 the volume of the annual turnover of railroads went up by 9.0 percent compared with the previous year.

Corruption has become as high-profile issue in Ukraine as it is in Latin America. Five Latin American countries (Paraguay, Honduras, Colombia, Venezuela and Ecuador), as well as Ukraine, appear among the Transparency International's twenty-five most corrupt countries (Table 9).

As an example of the growing bureaucracy in Ukraine we may cite the following fact. Despite the fact that during 1992-2000 Ukrainian GDP almost halved, the government expenditures on the state administration have increased by more than 50 percent. Their share in total budget expenditures grew from 2.2 percent in 1995 to 7.0 percent in 2000. Administrative intervention resulted in the highest time tax on management that was observed among 20 transition countries in 1997 (EBRD Transition Report, 1999).

Subsection 4.2: Excessive and unstable regulation

Instability of the business environment is a powerful tool that the state bureaucracy uses to exercise its gains from informational asymmetry. Together with the discretionary or discretionary enforced regulations it is widely used in Ukraine to gain an administrative rent, although at the lesser magnitude recently. Below is just a short list of the most striking examples.

During 1996-1997 the government has made 1,500 amendments to the excise rates on alcohol and tobacco products. The Customs Service has

spent an enormous amount of time on preparing the national Customs Code, which consists of a lot of contradictions with the international standards. The value-added tax implemented by the Government's decree in 1992 was subject to a dozen of further corrections until the new law was adopted in 1997; then the latter has been amended more than 200 times in two years. The number of legislative (normative) acts regarding non-monetary means of payment grew tenfold. While in 1995 just ten of such normative acts were in circulation, by 1999 their number grew to 101. This increase is well explained by a rise in the number of "selective" normative acts allowing non-monetary payments for certain business units. The regulation of business activities initially included licensing of just eleven activities; by the end of 1997 the list of such activities has increased to ten dozens; then it was more than halved by the IMF forced Presidential decree. However, in a few months more than a thousand of business activities were required to conduct the mandatory state certification instead.

The Cabinet has issued the regulation (#159, March 4, 1993) stipulating the mandatory licensing for exports of commodities that can potentially be used in the military production. Together with toxins, explosives, radio absorbing surface covers, etc., the list includes such goods like polyethylene, ammonia, methanol, polyamides, and pumps.

Another example concerns the real estate. In the 1990s, Ukrainians instead of making deposits to the fragile banks preferred to invest in purchases of houses and apartments. In 1997 the volume of such operations amounted to UAH 7 billion (7.5 percent of GDP), while the volume of bank savings of households was 4.3 times lower totaling just UAH 1.6 billion (1.9 percent of GDP). However, the powerful lobby in the Parliament prevents the establishment of the clear rules (adoption of the Housing Code, the Law on Real Estate, etc.) regulating the real estate market. In accordance with existing legislation, the exchanges are heavily involved in real estate transactions. But, the Justice Ministry periodically threatens to revoke the deals concluded beyond the state notary offices.

The Anti-Monopoly Committee, the government body sealed in the Constitution, does not have enough power to cope with the activity of 378 monopolistic structures on 562 national markets. Now the practice of exercising rents, which is widespread in the conventional sectors of the economy, may spill over to the new ones such as Internet and cryptography.

Subsection 4.3: Poor contract and law enforcement

This problem in transition is pretty well studied in the literature. President Kuchma, who admitted that 40 percent of his instructions in 1999 were not implemented, directly confirmed the fact of the poor enforcement. In

Ukraine, similarly to Russia, the government itself acts as the main violator of law, although in Ukraine it is more evident than in Russia. The government plays some sort of a game, allowing selective economic agents to breach the laws, while punishing the others for the same "sin". For example, Table 10 compares the percentage of execution of the planned budget revenues for the transit of the respective commodities through the Ukrainian territory for the "favorites" (the gas traders), former "favorites" (the oil traders) and non-favorites (the ammonia traders) in 1999 and 2000. Noteworthy, the payments for ammonia transit were for the first time scheduled among the budget revenues in the 1999 budget. This kind of payments that amount to USD 2-3 million annually was neglected before.

The level of tax arrears remains high. Among the main debtors are the "favorites" from the basic sectors, who permanently press for writing-off debts. Obviously, this does not stimulate the strengthening of the financial discipline. According to the latest write-off in correspondence with the Law "On the Order of Redemption of Liabilities of Taxpayers to the Budget and State Targeted Funds", effective since April 1, 2001, the State Tax Administration (STA) has written off UAH 11 billion (6.4 percent of GDP), or 92 percent, of fines and penalties, and UAH 7 billion (4.1 percent of GDP), or 54 percent, of tax arrears.

As in Russia, wage arrears in the budget sector was a common practice. At the end of 1998 they amounted to UAH 881 million (USD 257 million), but then were decreased to UAH 262 million (USD 48 million) by the end of 2000. However, since August 2001, there are signals that the trend of re-emergence of budget arrears is visible in some regions ("100 days of Mr. Kinakh's Government", 2001).

In Ukraine, similarly to Russia and Latin America, the discriminatory playing field forces agents to cheat. In the heart of the problem is the government failure (unwillingness) to maintain fair contract enforcement. Contract enforcement is the most important task that the government has to provide for a market economy to function. We consider the problem of tax avoidance as a self-introduction of the long-awaited tax reform by economic agents.

The government tries to fight tax evasion forcefully, thus increasing the opportunity cost of it. Western donors also help in the strengthening of the STA. Such Ministries exist only in seven countries, including Nigeria, Columbia and the Russian Federation. This separate Ministry is subordinated not to the Finance Ministry but directly to the Prime Minister (actually, to the President). But whilst the uneven playing field persists, these efforts are destined to failure.

Let us assume the following game. There are two major players; businesses A and B competing on the same market and having initially equal market shares. Let the long-run cost of tax evasion be actually higher than of paying taxes. If A and B both pay taxes, they have similar production costs and can maintain their market shares having a profit of 4 each. If instead they both evade, they again are equally competitive but get only 2 each. In addition, the government receiving less in tax payments from both of them and spending relatively more on the tax collection may lose its capacity to perform its duties in the infrastructure (Hellman, Jones, and Kaufmann, 2000). But for each of the players, the worst case is when their strategies are different: if, say, B successfully evades taxes, it becomes more competitive (in the short-run) and can push A out of business. If A will obey the law, then B will probably suffer from tax inquiry, but, having the whole market in its disposal and hidden profits, may hope to bribe tax officials. Moreover, in reality B can have good contacts with some big guys, and hence a lower risk of being punished for tax evasion. That would further destroy the incentives to pay taxes.

Table 11. Prisoner's Dilemma in Taxation

		B	
		Pay taxes	Evade taxes
A	Pay taxes	4, 4	0, 6
	Evade taxes	6, 0	2, 2

If none of the players knows the strategy of another player, we would have a Prisoner's Dilemma (Table 11). So, each player will gain from not paying taxes or bills, outcomes (6,0) and (0,6), but both are better off if neither chooses to cheat (4,4). The role of the government, which knows the payoffs, is to enforce a preferred solution, namely, the cooperative solution (Pay, Pay). It will bring the economy to Nash equilibrium. In the case of the inefficient government policy the players choose (Evade, Evade), and the economy ends up in a bad equilibrium.

However, in reality, players are aware of the likely behavior of other agents, because of the widespread tax evasion and an environment with non-monetary forms of payments. Even the pro-reform government of Yushchenko had to allow the mutual offset to the tune of UAH 3.1 billion (USD 570 million). Our illustrative game indicates well the consequences of the government's inability to keep words. The government arrears on the VAT refunds to exporters (Olearchyk, 2001) grew from UAH 380 million

at the end of 1997 (USD 203 million) to UAH 4 billion (USD 755 million) in November 2001. At the same time, enterprises owe the budget nearly the same volume of the VAT payments, namely, UAH 3.9 billion out of the total UAH 11 billion, as the government owes VAT refunds to them. So, both sides found themselves in the bad equilibrium. Meanwhile, "some fortunate exporters, presumably companies close to high ranking officials, get VAT refunds on a timely basis" (Olearchyk, 2001).

The degree of improvement of contract enforcement depends on the overall efficiency and the level of corruption in the government and legal system. The government must settle its own bills in time to expect economic players to do the same. Introduction of foreign players might help to raise a discipline; however, some foreign companies are also involved in this type of behavior. It is important to produce a positive signal in order to escape the bad equilibrium.

Financial delinquency may also be viewed as a result of an asymmetry between the domestic and foreign players, or of protectionism, which could hurt non-residents (Subsection 3.4). Expectations of the depreciation of the domestic currency, heavily supported by "captains" of the basic sectors, encourage incentives to run domestic arrears. And, due to the existing links between the government and businesses, it does not create a threat of bankruptcy.

Subsection 4.4: Absence of real bankruptcy

The lack of the effective bankruptcy procedures leads to a weird situation when half of enterprises are loss making without any sound consequences such as bankruptcy. Protecting those companies that cannot pay their bills against bankruptcy leads to the dissemination of weak contract enforcement and rent seeking. Actually, the anti-bankruptcy policies in fact promote bankruptcies, although the "hidden" ones. They result in a growing number of really bankrupt enterprises that are allowed to operate despite their value subtracting status. These companies certainly do not pay due taxes and some non-monetary transactions become imminent.

The high aggressiveness of tax authorities seeking profitable companies stimulates the firms to generate losses rather than profits, and to move some of their activities into the shadow. Officials discretionally decide which companies will be allowed to function and to use non-monetary methods of tax payments.

Enterprises use barter to maintain the cycle of indebtedness, helping them to avoid restructuring. This resistance to restructuring gets support from the government (Commander and Mumssen, 1998). By allowing enterprises to pay taxes in kind, tax offsets provide an incentive to avoid restructuring."

(Ickes and Gaddy, 1998). Typically, an official reason to avoid bankruptcy, as preached by the government, is to protect employment. In fact, such policy keeps the old inefficient enterprises operational. While this policy “has protected jobs and reduced social unrest, it has done so at the cost of retarding the momentum for privatization and restructuring and encouraging barter” (Thirsk, 2000). It is argued that since many enterprises are potentially insolvent, the bankruptcy of some of them could cause a chain of bankruptcies. In fact, the entire legal system provides effective anti-bankruptcy protections. Creditors do not have much chance of benefiting financially from initiating bankruptcy actions. Thus, in the case of a loss-making enterprise, some barter arrangements would work much better both for the creditor and debtor. The government protects these enterprises by enabling them to “swap products they could never sell”.

Barter *per se* is not the main problem of Ukraine’s economy. “The institutional policies that effectively support soft budget constraints (barter, arrears, non-monetary forms of payments, shadow operations, etc.) are actually harmful for the business environment” (Szyrmer and Besedina, 2001).

Subsection 4.5: Soft budget constraints and non-monetary means of payments

A Soviet-style SBC principle (Kornai, 1992) remains the keystone of the government’s policy in Ukraine. The government uses high tax rates and other fiscal confiscation measures to extract money from profitable enterprises in order to support inefficient enterprises. Different non-transparent payment arrangements, including barter, enable this policy.

The whole system of the “economy of favors” was based on the barter with favors among the nomenklatura members. One of these favors was a supply of scarce commodities (“deficit”) on the mutual offset basis. In the early 1990s barter was practiced more implicitly. Enterprises simply kept exchanging products at prices covering costs, while the state sought to generously subsidize these prices. The main problems were the sharp increase in the cost of energy, markets’ shrinkage due to the new political reality and shifts in demand. This multilateral “implicit” barter among enterprises, over a longer period of time, was a recipe for disaster. The Ukrainian authorities carried out the policy of the government control of the majority of enterprises and the maintenance of almost full employment. As a result, GDP declined and inflation exceeded 10,000 percent in 1993. Under such conditions barter was a convenient way of doing business, although all transactions were formally expressed in the monetary units and primarily were not officially recognized as barter transactions.

Non-monetary forms of payments became an obvious choice of enterprises under the following governmental policies:

- ✓ high inflation;
- ✓ high fiscal deficit;
- ✓ very high cost of bank credits;
- ✓ tax arrears, tolerated by the authorities;
- ✓ frequent debt write-offs;
- ✓ official avoidance of bankruptcies of loss making enterprises;
- ✓ slow and nontransparent privatization,
- ✓ volatile exchange rate;
- ✓ gradually increasing impediments to foreign trade.

Barter was a continuation of the Soviet-era activities. Over time explicit subsidies to commercial enterprises declined from 17 percent to 4 percent. This occurred under the IMF supervision in 1995 as a result of anti-inflationary efforts aimed at cutting the budget deficit.

The SBC policy, through which the authorities chose “favorites” or “milk cows”, is the key to bureaucratic controls over the economy. The paternalistic treatment of some enterprises requires a harsher tax burden on other ones, enabling authorities to collect revenues and to continue the micro-management of the economy. In a non-discriminating environment, the importance of ruling circles would not be so significant.

Taxes and other payments are the main measures enabling a large scale redistribution of incomes, implemented partly by the rules (high tax rates), and partly by discretionary decisions of the authorities (“mutual settlements” deals (The Barter Economy..., 2000); penalties for some taxpayers and tax debt write-offs for others, etc.). The idiosyncrasy of the tax system and high tax rates and payments are emphasized as important factors determining the choice by enterprises of the transaction types. According to (Yakoub, Senchuk and Tkachenko, 2001) 22.3 percent of sales in 2000 were paid by barter and other non-monetary forms of payments.

Barter in Ukraine and Russia

There are similar patterns in the use of barter in Ukraine and Russia. Before 1995 barter remained at a relatively low level. In 1995-1997 it grew from about 20 to 40 percent of total sales of industrial output. In 1998 the share of barter in total sales of the manufacturing sector reached its peak

(around 50 percent) in Russia and remained stable at approximately 40 percent in Ukraine. Since then it was shrinking in both countries (Figure 6).

Under unsafe property rights and poor contract enforcement, barter helped to reduce the risks. However, the specific feature of Ukraine is that the government itself is actively involved in the promotion and/or preservation of the non-monetary means of payments, while in Russia the barter deals are concluded primarily among enterprises. The world's biggest barter deal is the Ukrainian-Russian agreement on the annual supply of 32 billion cu. m. of the Russian natural gas to Ukraine as a payment in-kind for the transit of 110-130 billion cu. m. of gas through the Ukrainian territory. When some professionals in the government decided to demand payments in the monetary form, the influential lobby from the President's administration terminated this idea. In 2000 President Kuchma has intervened personally in the process when the former first Vice Premier Y. Tymoshenko was ready to reach an agreement on a supply to Ukraine of the Turkmen's natural gas that would be paid in a monetary form only. After that interference, the signed agreement includes provision on a 50-percent payment in goods, works, etc.

The clear example of the open participation of the government in the legalization of the non-monetary means of payments is the creation in 1998 of the special state company Ukrspetsfin, which was involved in the operations with the exchange, discounting and accounting of debts, and the schemes involving mutual cancellation and promissory notes. It was dissolved at the end of 1999 by one of the first Yushchenko's decrees.

So, until 2000 the government actually blessed and led the process of dissemination of the non-monetary means of payments instead of fighting them. This policy was allegedly aimed at the protection of jobs, but "high" employment in the idle Ukrainian enterprises did not lead to GDP growth. When this policy was abandoned in early 2000, it has not, evidently, led to any rise in unemployment, but resulted in the GDP growth. We consider this result as the manifestation of the increasing rate of "creative destruction".

Subsection 4.6: Labor market: job creation and job destruction

While ruling circles fail to formulate a clear strategy of development, the Ukrainian labor market experiences profound adjustments associated with the transition period.

As a result of adverse demographic and labor market conditions employment in Ukraine dropped from 24.5 million people in 1990 to 21.8 million in 2000 (OAB, 8/03/00). Unemployment has been steadily increasing since the beginning of transition. As measured by the number of officially registered unemployed, unemployment rate in Ukraine has reached 5.3 percent by the end of 2000. According to ILO, the

unemployment rate is about 12 percent. The highest estimate of unemployment rate was made by the Head of the Parliament's Committee on Social Policy and Labor Issues (Hoshovska, 2001), who announced that the actual unemployment rate in Ukraine reached 26.22 percent. An alarming development in Ukraine's labor market is an increasing duration of unemployment. It is estimated that about one-third of job-seekers (including unregistered ones) failed to find a job during one to two years, while the other one-third has remained unemployed for three years and more (OAB, 2/10/00).

The process of economic restructuring is expected to manifest itself in a high rate of job turnover (defined as the sum of job creation and job destruction rates) as (and if) firms seek ways of enhancing production efficiency.²⁸ The evidence suggests, however, that so far the job turnover in Ukraine has been dominantly driven by job destruction rather than job creation.²⁹ For instance, based on a sample of 300 firms in Kyiv and Dnipropetrovsk (a sample is not representative for Ukraine as a whole), Konings and Walsh (1999) found that in Ukraine from 1991 to 1996 the rate of job destruction increased from 7.8 percent to 15.3 percent, whereas the rate of job creation grew, mostly at the account of de novo firms, from 0.1 percent to 2.5 percent.³⁰ The average net employment growth rate in 2000 was -3 percent (Yakoub, Senchuk and Tkachenko, 2001). However, employment growth rate varies a lot by sector, type of firm ownership and firm size (Table 12). It is worth noting that those sectors (industry and construction) that have been identified as having the highest slackness (in terms of excessive labor) by our logistic analysis using 1995 data (Table 13) exhibit the highest shedding of labor according to the 2000 firm-level data. This suggests that active economic restructuring may indeed be on its way in Ukraine now. Yet, the evidence indicates that on average only de novo firms have so far contributed to job creation.³¹ The fact that these firms were able to combine positive rate of employment growth with rising productivity (Table 14) suggests that private sector can serve as a main facilitator of both job creation and economic recovery in Ukraine.

²⁸ Although representing a necessary step toward achieving long-run efficiency, worker displacement during the transition may have severe short-run implications for growth as it involves the destruction of firm-specific human capital.

²⁹ That may suggest (not surprisingly) that Ukraine is still very far from entering a mature stage of transition, where job creation equals or dominates job destruction, as observed in several transition countries of Central and Eastern Europe (Faggio and Konings, 2001).

³⁰ The comparison (tentative, since firm samples are not fully comparable across countries) to Poland, Estonia, Slovenia, Bulgaria and Romania indicates (using data on job destruction and creation in these countries from Faggio and Konings, 2001) that the rate of job destruction in Ukraine has been generally higher (probably reflecting less favorable initial conditions such as over-industrialized economy), while the rate of job creation has been lower (due to paternalistic policy of supporting the existing entities rather than facilitating the creation of the new ones, limited regional mobility, etc.).

³¹ The emerging pattern is that job destruction is driven by the old firms' downsizing or exiting, while job creation by de novo firms' creation (market entry) and expansion.

Nonetheless, the possibilities for a fast job creation can be hindered by, among other factors, an unfavorable initial sector structure of the economy. Garibaldi and Mauro (1999) argue that the initial allocation of jobs by economic sectors is a significant determinant of overall job creation, and that countries with larger shares of employment in agriculture and traditional manufacturing are expected to be among the slowest job creators. Ukraine's perverted economic structure marked with the preponderance of industry and inefficient agriculture, and a continuing apathy of ruling circles to structural reforms, makes the process of job creation difficult and slow.

However, in the present conditions labor force is mostly concerned not with finding jobs as such, but with securing high wage jobs (by local standards, of course). It is also very common to hold multiple jobs and/or work extra hours to compensate for insufficient income from a regular employment. Despite 9.1 percent growth in GDP in 2001 the average monthly wage was close to just USD 70, while the dynamic and educated people were seeking earnings starting from USD 300 and up. According to (Hoshovska, 2001), there are 120,000 Ukrainians working illegally in Italy, 100,000 in the Czech Republic and Slovakia, 50,000 in Spain, 25,000 in Portugal, etc. However, according to the Ministry of Labor (TV Channel 1+1, November 2, 2001) the number of Ukrainian citizens working abroad varies from 1.5 to 2 million people. The vast majority of them simply avoid costly registration in the Ukrainian consulates.

Absence of the faster high-wage job creation cannot provide a mechanism for the increase in country's output. Millions of Ukrainians, being tired to wait for economic restructuring, are voting for higher wages and better living conditions with their feet. Employment-stimulating policies, such as lower worker dismissal costs and lower taxation of labor earnings, may have important mutual spillover effects on job creation and economic growth. However, these policies will be fruitful only if accompanied by improvements in the business environment and changes in the rent-seeking behavior of ruling circles.

Section 5:

Crisis-1998 as a Turning Point for Growth (1998-2001)

Subsection 5.1: Depletion of sources of rents

As we noticed in the previous sections, ruling circles of Ukraine used numerous opportunities to gain lofty rents within a limited time horizon. The only hope for growth to come was in achieving the moment when these rents would be over.

After the Asian crisis in the fall of 1997, the fever of crisis approached the big emerging markets on the other continents – Brazil and Russia. The economic policy of the latter despite the huge foreign assistance and inherited infrastructure of the superpower (more qualified government servicemen, membership in the international organizations, trade missions abroad, permanent currency, moderate reserves of the Central Bank, etc.) was far from sound. The Russian finance was in total disarray. The heavy reliance on domestic Treasury bills (GKO in Russian abbreviation) and forward contracts in conditions of absence of structural reforms led to a financial “heart attack”. The third stroke in August 1998 was crucial. Russia has announced default on servicing T-bills.

In behavior of the Ukrainian authorities in 1998 domestic political considerations – upcoming spring 1998 Parliamentary elections - had prevailed. The frictions in relations with the IMF and World Bank became clearly distinguished at the end of 1996, when the legislative initiative known as “The package of economic growth” was not approved by the Parliament. One of the main reasons for this was a passive position of the Presidential Administration, which was happy with the current rent revenues and not interested in the real changes. With a certain degree of hypocrisy the authorities twice (in January and June 1997) had refused to cancel subsidies on housing rents and communal services, although it has been stipulated in the Memorandum between the IMF and the Government of Ukraine.³² Although such a move was explained by the desire to protect low-income strata of population, actually it led to extra profits of T-bills holders. The anticipated cost of increase of communal services, leading to an increase of the CPI by 10-15 percent, and, consequently to deducting

³² This issue is indeed much more complex. The increase in prices has to be preceded by the comprehensive reform of the public utility sector that is still postponed.

profits of T-bill buyers, has already been assumed in the price of these securities. Due to the more favorable economic situation (decline in inflation, introduction of the full-fledged currency) since June 1997, the government has begun to demonstrate its illusory independence from the IFOs by relying on short-term speculative capital flows into domestic T-bills and the fiduciary loan from Chase Manhattan in August 1997.

The idea of conservation of the situation “rents instead of reforms” was deeply embedded in the minds of authorities. Being reluctant to implement structural reforms, in February and March 1998 they surprised the world making a debut on the Eurobond market by issuing bonds at the exorbitant 16-percent interest rate. The rent cycle continued and in March 1998 the government has deliberately violated the budget deficit benchmark using international funds not for their primary target but for some repayments of pension arrears, which caused an anger of the IMF and termination of the stand-by program in April 1998. The idea of the Big Sweet Carrot – the Extended Fund Facility - financing has almost disappeared.

The next important date for the ruling circles was November 1999, the time of the presidential races. Some sources of short-term rents (credit lines, grants) have been exhausted. Anyway, the authorities had at their disposal some other options for maintaining a status quo: further increase of wage and pension arrears, reliance on T-bills and a chance of borrowing from private Western and Japanese financial institutions. On April 16, 1998 the government has passed the resolution increasing the volume of the Treasury bills issuance four-fold from UAH 2,997 million (USD 1.3 billion) to UAH 11,472 million (USD 5.1 billion).

So, they tried all these options and it helped to withhold the day of inevitable breakdown. The reserves of the National Bank of Ukraine fell to a historic low after servicing the loan from Nomura. The day of default was visible at the middle of November 1998. But the passivity and confidence of Ukrainian elite was really striking. This peculiar game ended in the fall 1998 with a deep crisis. However, the Ukrainian authorities were lucky to escape an even deeper financial collapse because Russia had fallen first. After that the Ukrainian conditions of T-bill restructuring “30 cents for 1 dollar” looked attractive comparing with the Russian “10 cents for 1 dollar” ones.

Since the fall of 1998 the Government had to abandon the attempts to secure funds from private and government external sources. However, the authorities were supported by the IMF, which was fast enough to resume financing under the EFF terms. Soft political conditions returned. The idea of a further resumption and expansion of the T-bill market has been promoted by the IMF advisors. However, at this time sober-minded professionals from the Ukrainian Finance Ministry and Ukrainian commercial banks protested. The credibility of the monetary authorities

was undermined and the National Bank of Ukraine became the only buyer of domestic T-bills on the primary market. This way before 1998 Parliamentary elections UAH 92 million (USD 46 million), and before 1999 Presidential elections UAH 402 million (USD 90.3 million) were issued for the partial redemption of the pension arrears. This threat of default was even more realistic, since after the 1998 currency devaluation the government has frozen some important prices, as for electricity and wheat grain, for the same political reasons. These prices were to be inevitably raised or liberalized because they did not cover the true cost.

In addition, the Presidential Administration unofficially banned the switch-offs of the large industrial firms for the energy arrears up to the elections date, which resulted in UAH 9 billion increase in this kind of arrears with the fuel shortage as an inevitable consequence.

The ruling circles still continued to rely on energy rents. For this the government agreed to lower tariff rates for transit of Russian energy supplies through the Ukrainian territory, missing budget revenues but gaining new rents. Some Western financing has resumed in 1999 but it was not used productively and by December 1999 the government was in a triple emergency situation:

- it lacked funds for servicing external debt obligations
- the energy system was at the brink of collapse because of shortage of fuel, and
- the year of 2000 could bring another wave of high inflation.

Under the pressure of external creditors the ruling circles agreed to appoint a limited number of people with pro-market reputation to the top positions in the government. Although at the end of 1999 the elite could still get some sources of rent from the Russian counterparts, their position after the change of administration in Moscow became tougher.

Subsection 5.2: Semi-default and pro-reform policy

Unlike Russia and other energy abundant countries, Ukraine lacks resources to support her energy-inefficient economic structure and can not afford it any more. This fact became obvious after the 1998 crisis. Actually, every late fall the same story repeated: due to the non-payments and non-equivalent barter the energy sector suffered from the fuel shortage and the respective minister reported to the President that in a few weeks the energy system would crash unless some funds be granted for the purchase of fuels. There were two main ways of solving this problem: State subsidizing (the notorious illegal consumption of gas was indeed paid by the government anyway); and squeezing of payments from the customers. The first was shrinking year-by-year due to the contraction in

the State's capacity; the second one (the hardening of the budget constraints) has expanded. Interestingly, right after a few hundreds of non-payers were switched off, the others have always found some cash to pay for electricity and the problem has been solved – just for one year. The situation was particularly severe in 1999, when the external resources of financing were exhausted and Russia started to impose hard budget constraints.

Yushchenko's Cabinet appointed in December 1999 has made a crucial step in the de-virtualization and tightening of the financial discipline. The new people in the government had to find new sources of financing and they decided to increase revenues through acceleration of privatization, thus strengthening the base of reforms. The government policy became less paternalistic because the reform-minded people did not held leading positions in the government before and had no direct connections with "captains" of loss-making state-owned enterprises. The adoption of a deficit-free budget had also made its impact on government activity. Another real opportunity for the increase in budget revenues was a stricter financial discipline and attack on non-monetary means of payments.

The quality of Cabinet's legislative documents also improved drastically. Even at the first glance the difference between the period of 1992-1998 and the year of 2000 is striking. By our data, for the whole period of low prices for energy inputs, 1992-1993, only few documents devoted to the hardening of payments were adopted, instead a majority was devoted to granting the firms write-offs and privileges. In 1996 the main flow of documents was devoted to the special barter schemes of payments; in 1998 for mutual settlements and arrears. But the major vector, as well as a style, remained pretty similar, although slowly evolving. In 2000 the hardening of the budget constraints was a major direction for Cabinet's policy. Although this policy remained quite controversial, the many issued orders were devoted to the cancellation of previously granted privileges.

First, the government succeeded in restructuring of the external debt, which gave it more room to maneuver.

Second, the government carried out the liberalization of the monetary and exchange rate policy. The depreciation of the hryvnia has eliminated the macroeconomic consequences of the pseudo DD (Section 3). The domestic high-effort goods became more competitive, although it would not happen if their manufacturers did not undergo the post-privatization restructuring in 1995-1998. For example, by 2001 Ukrainian companies regained control of the domestic food market having the 94-percent share, while in 1995, the year of the same real exchange rate, their share was below 40 percent. As a result, the composition of exports improved and trade balance became positive (Dubrovskiy and Shygayeva, 2000). Another important outcome was increase in the money demand.

Third, the mutual budget offsets were officially forbidden, as well as the barter in the energy sector. Although later the government has violated this commitment, initially it has played an important role in the suppressing of the “offset expectations”, one of the most important cornerstones of the “virtual economy” (Ickes and Gaddy, 1998). The non-monetary transactions fell drastically - that further contributed to the increase in money demand.

Finally, the personal factor has played its role: the new government prepared a monetary surprise. Because V. Yushchenko had a reputation of a tough monetarist, nobody of economic players expected a dramatic 45-percent increase of the money supply. But because of the above listed factors, such an expansion resulted in just 25 percent inflation, mostly caused by the liberalization of grain prices. This non-inflation emission along with an increase of budget revenues due to the hardening of the budget constraints allowed some repayment of wage arrears and full redemption of pension arrears that improved the purchasing power of households. Rising domestic consumer demand turned out to be one of the significant components of growth-2000. This part was missing in the previous decade.

The increase in real GDP can also be partially explained by the increase in the demand for the traditional Ukrainian exports (metals and chemicals). But although this factor explains roughly a half of the achieved growth, the second half is owed to the deep structural changes and changes in the management of privatized enterprises (Subsection 5.3). In 2000 for the first time positive correlation between growth and deepness of privatization was observed at least on the cross section of two dozens of sectors (Shygayeva, 2001). It means that even the voucher privatization, nonetheless, partly succeeded in the creation of the more active economy actors.

On the other hand, in 1999 after the sound struggle of small businesses' lobby accompanied by strikes, the new simplified system of taxation for small businesses was introduced. It has provided small private enterprises and self-employed with the opportunity of considerable reduction of an administrative burden in exchange for the higher (on average) payments to the budget. As a result, the revenues from the respective sectors of business, like flea market retailers, have grown six-fold in two years.

While market-oriented sectors demonstrated a sharp growth in 2000, the policy of paternalism was attacked by:

- ❖ an improvement of financial discipline, especially in the energy sector;
- ❖ acceleration of privatization (privatization revenues reached USD 383 million in 2000);

- ❖ freezing of the practices of granting tax privileges and the creation of new free economic zones;
- ❖ lowering the volume of the government purchases of T-bills on the primary market (the planned volume was fulfilled by 60 percent);
- ❖ the 9-month external borrowing “holidays”;
- ❖ dissolution of the agricultural collective farms which laid ground for a 9.9-percent growth in this sector in 2001;
- ❖ some progress in an administrative reform.

Such developments, however, could not satisfy appetites of rent-seekers who, according to the former First Vice Premier Y. Tymoshenko, lost in foregone rents up to UAH 9 billion (USD 1.8 billion). She has been dismissed in January 2000, while the destiny of Prime Minister Yushchenko was decided three months later.

Coming back to Figure 6 (Subsection 4.5), we see that the fall in barter was strikingly high in Ukraine. At the end of 2000 barter transactions constituted 17.3 percent in Ukraine (8.3 percent in 2001), and about 30 percent in Russia, that is, in Ukraine it has fallen almost half as much. However, in Russia (Gaddy and Ickes, 2001) the sharp devaluation of currency per se automatically led to the visible contraction in barter without any real restructuring. It is very important for the primary resource exporting economy, like Russia, and is less sound for Ukraine. This effect is directly related to the rate of devaluation that was twice as much in Russia. We may conclude that despite the shock of the August crisis in Russia was painful, Ukrainian firms indeed has changed their behavior much more significantly than their Russian colleagues did. Why?

Here we seem to find an important although indirect evidence for our hypothesis of the blessing Ukraine with the exhaustible sources of rents that seemed to come to the end in 1998-1999. In Russia, the default was followed by the substantial increase in the oil prices that brought additional flows of macro rent for the country, which partly compensated for the losses. Moreover, having extremely cheap (due to the ruble’s devaluation) energy and gas, Russian producers of by-products became especially competitive, whilst their Ukrainian colleagues having not enjoyed such privileges lost. For Ukraine, the maintaining of low prices for electricity was threatened with the energy system crash that finally has made some reforms, mainly hardening of the budget constraints, unavoidable.

The same patterns are observed in other sectors too. When the state stepped aside from the organized subsidized supply of gasoline and other oil products for agricultural planting and harvesting, their consumption of

those products in agriculture halved (Sabluk, 2001).³³ Anyway, there is a steady lowering of the annual consumption of gas. For example, consumption of this commodity totaled 75 billion cu.m. and 72.5 billion cu.m. in 1999 and 2000, respectively. During January-August 2001, it fell by another 6 percent comparing with the corresponding period of the previous year.

Taking into account the data on electricity and gasoline losses we may expect that after the gas market liberalization the annual volume of the natural gas consumption would fall from 15 to 50 percent, leading to savings from 12 billion cu.m. to 36 billion cu.m. The money value of possible savings could reach USD 1-3 billion (3-9 percent of GDP). Adding the electricity losses (Subsection 3.3), we conclude that by the hardening of the budget constraints in the energy sector Ukraine can get saved up to 10 percent of GDP annually.

Subsection 5.3: Recent developments

After the dismissal of Yushchenko, the economy has continued its upward trend although the rate of growth began to slow down. While the GDP growth reached 10.8 percent in January-June 2001, it declined to 9.1 percent in 2001, and 3.8 percent in January-May 2002.

During the whole year after the appointment, the government headed by the Head of the ULIE Mr. A. Kinakh failed to formulate the objectives of the economic policy. One reason for this was a burst of administrative bureaucracy and introduction of positions of state secretaries. The government agreed to such administrative innovations having shown the lack of political will and strategic vision. The state bureaucracy even worsened:

- ministers, who were fired for inefficient work returned to the top positions in the government;
- the government is conducting a policy of selective support of certain regions, sectors and enterprises;
- Mr. Kinakh admitted non-readiness of his government to spur Ukraine's accession to the World Trade Organization and European structures;
- the Ministry for Industrial Policy, a home of paternalism and protectionism, has been restored; it announced the ban on bankruptcy sales of loss-making enterprises and the decision to exercise control over strategic companies.

³³ It does not mean, however, that the whole of these 50 percent of a motor fuels were indeed lost or wasted; rather the major part of it was stolen or sold by the market price.

Strange enough, but the international financial organizations, which were reluctant to give a hand to the pro-market government headed by Yushchenko, have found such a traditional policy quite satisfactory to help with new loans. Having received enough funds from the IFOs, ruling circles concentrated on the parliamentary elections in the spring 2002. They are, definitely, not in a hurry to privatize loss-making enterprises, improve a financial discipline in the energy sector and carry out the administrative reform. Such a policy conducted by the rent-givers with respect to the same rent-takers as in 1994-1999 is questionable and leads to nowhere but the preservation of the incumbent ruling circles and withholding of the structural reforms

These developments suggest that recent economic growth is under a threat because it seems not to be supported by the selection of less paternalistic business entities.

Using the same IFC survey data we have estimated the probit regressions for the indicators of business expansion – growth in revenues (2000 comparing to 1999) and in investments in 2000³⁴ (the Spearman's correlation coefficient between the two is 44 percent) as dependent from the business culture (for description of proxies see Subsection 3.4). We have added the Having Subsidies variable that is equal to zero if a firm did not have subsidies (in a broad sense, included tax, energy and utility arrears) neither in 1999, nor in 2000; 1 – if it took place just in 1999; 2 – if it was subsidized just in 2000; 3 – in both years. Our idea was to assess the direction and strength of the business selection (Subsection 3.1) in Ukraine as a result of reforms. The results are presented in Table 15.

As an evidence for hardening of the budget constraints we have found the firms having arrears on average have much lower probability to achieve the revenue growth. We have also found (not reported) the industrial firms' investments to be positively correlated with having profits. It is consistent with Dubrovskiy et al. (2001), who observed (using another set of data) the same patterns for investments in 1999, although, the opposite – negative relations between investments and a set of indicators for the quality of management – were observed in 1998.

What is encouraging is that the market-oriented culture, including external openness, at last has started to widespread with investments. However, we cannot always state the same for the revenue growth.³⁵ The most competitive firms, the exporters, certainly make more investments. Also, those firms that have marketing and business planning are investing.

³⁴ Firms reported just the fact that they had growth or made some investments regardless to the volume.

³⁵ For the industrial sector, however, this is also true.

The impact of the Social Responsibility variable to the growth is rather negative despite the fact that it can serve as a proxy for the firm's viability. Thus, Ukraine's growth in 1999-2000 will be hardly accompanied by the same rate of tax revenue growth. This is exactly the case for 2001. On the other hand, positive signs on the respective coefficients in the investment regression may be just owed to the better performance of the firms reported higher affordable tax burden.

But what is really disappointing, no relation is observed between the paternalistic attitude and investment. While the coefficient on arrears is negative, the one on the paternalism is positive, although they are statistically insignificant. Also, those firms that have subsidies (both open and hidden) have actually even more chances to grow as those that do not have them. It means that the ROP is still in place and the selection is still going along the lines of paternalism and the ROP. Thus, the risk of continuing the ROP, including the restoration of SBC to the previous (observed prior to 1998 crisis) levels, remains pretty high.

Section 6:

Assessment of potential for creation of the new institutional environment and medium-term growth

There are a few “purely economic” restrictions on the rates of growth for the small catching-up economy bordering with the first-wave EU candidates and having high transitivity and relatively good infrastructure, as well as educated labor force with high potential for creativity. The major restrictions are the political and economic formal and informal institutions. Now the controversial tendencies in their evolution, as well as in the population and elite behavior are observed. The new elite will unavoidably replace the old nomenklatura due to the natural rotation in a decade, but what kind of elite will be this new one? If it will be blessed by the predecessors and follow their traditions of paternalism and closeness, we come to the pessimistic scenario. If, on the other hand, pro-market forces will successfully replace the paternalistic ones during the coming elections, Ukraine has a chance to approach a steady two-digit growth revealing its long-term advantages in creative and skilled human capital. We believe that this is just a question of time for Ukraine to enter the period of steady growth, although such an evolution can take a decade or even more. During this period the permanent political struggle will make the situation unstable and hardly predictable.

Subsection 6.1: Pessimistic scenario: old-minded elite, resource-oriented policy

In the pessimistic scenario the following major conditions are expected to prevail:

- no change in elite selection;
- resource-oriented policy (supply of inputs, protectionism, credit and monetary expansion);
- marginal and heavily distorted market selection;
- widespread rents, non-market incentives;
- external soft budget constraints and rents;
- possible crash of energy system; devastation of fixed capital;
- possible default on external debt;
- the preferred development of energy-intensive sectors based on the government's support.

The pessimistic way of development of Ukraine's economy under the old-minded ruling elite is linked with continuation of the resource-oriented policy of soft budget constraints, including:

- external soft political constraints (multi-vector orientation towards the West and Russia simultaneously) with maintaining of dependence on Russian energy supplies in exchange for political concessions and privileged privatization;
- soft fiscal policy (further increase of budget and enterprise arrears, reliance on Treasury bills and/or Eurobonds, writing-off debts, numerous regional and sector privileges);
- soft monetary policy (the high level of growth of money supply at 40-50 percent per year);
- Belarussian-Romanian-Turkish inflation (30-40 percent per year).

This will allow for the preservation of the existing source of micro rents and implies the partial reappearance of the major rent sources being in place prior to the 1998 crisis. It presumes the widespread rent seeking that will continue the crowding out of the productive activity across the economy. Piecemeal reforms will be conducted only under (primarily, external) pressure, and by the minimal possible extent necessary to escape an immediate crash.

Having these rents the authorities will avoid structural changes in the economy. Instead they will persist in trying to revive dead factories spending millions of hryvnias without prior marketing and feasibility studies. The foreign trade will be directed primarily toward Russia and CIS. However, if Russia joins the WTO in 2003, it will add headache for the Ukrainian exporters who may suffer additional losses of USD 1-2 billion per year. The share of Russia in foreign trade will increase making Ukraine's economy heavily dependent on the volatile Russian market and producing obvious impacts on the foreign policy.

The structure of foreign trade will remain almost the same and the annual imports of the Russian and Turkmen gas will stay at the level of 55-60 billion cu. m. or even higher. It is expected that Russia would pay no more than 10-15 percent in monetary form for the delivery of natural gas through the Ukrainian territory. The share of non-monetary payments and mutual offsets will increase again, although it barely can reach its incredible rate of 1997-1998.

The dual balance (the budget balance and balance of the current account) would worsen. The budget deficit will go up to 7-10 percent of GDP. The foreign reserves of the National Bank of Ukraine will fluctuate at the level of three-week imports.

The selective (special) approach for certain groups of taxpayers will not stimulate other enterprises to demonstrate profitability. The real budget revenues will go down, resulting in the deterioration of infrastructure; and authorities will rely on the "traditional" methods of covering budget deficit through the domestic Treasury bills, new wage arrears, external borrowing from the IFOs and Russia at high rates and/or at the expense of further concessions of aircraft, ships, information space, etc.

The domestic and foreign business circles will not welcome such a "traditional" policy. Evolution of the administrative control system will lead to the powering of executive branch, especially of its most bribe-intensive divisions, and sluggishness in strategic planning resulting in the decreasing government's capability. The high level of government interference in the economy will preserve high risks for doing business in Ukraine.

The loose fiscal and monetary policy will result in the depreciation of the national currency, which will follow the inflation caused by the increase of money supply by 40-50 percent every year. Combined with rising import restrictions it will lead to the appreciation of the real exchange rate not related to the increase in the economy's competitiveness, which will further hurt the latter.

However, expansionary policy will inevitably fail in the transitional economy with weak institutional environment due to:

- Inefficient bureaucracy;
- Widespread "special" relationships between politicians and big business;
- Corruption.

Although this kind of policy will come to an end sooner or later, the situation with human and health capital high raises concerns. Without sound improvements in the social and wage policy, rule of law, human rights, etc., the most dynamic and educated people will emigrate. Only in 2000 more than 800 Ph.D. holders left the country. The problem of the high rate of the AIDS dissemination exacerbates the situation. By some estimates, the number of HIV-positive patients reached 280,000 and is going up.

All in all, Ukraine's economy will return on track of a slow albeit steady decline.

Subsection 6.2: Baseline: a dual economy

In the baseline scenario the following major conditions are expected to dominate:

- slow replacement of the old elite by more competent professionals;
- limited, slowly shrinking rents concentrated in a few sectors with restricted access;
- shrinking external soft budget constraints;
- growth in the labor-intensive no-rent sectors with stagnation in the energy-intensive rent-oriented ones;
- domination of the incentive-oriented policy, both market-oriented (HBC for most of the economy; slow improvement in taxation and legislation business framework) and activist industrial policy.

The baseline scenario is based on somewhat stricter monetary policy and fiscal policy. Discretionary resource-oriented policy will continue, although at a lesser magnitude. Slowly shrinking sources of rents, particularly non-monetary payments and mutual offsets, will be limited within certain sectors of economy. The ruling circles will somewhat harden the budget constraints, hence allowing market forces to operate more freely. However, protection of domestic producers will remain priority #1 and will be conducted through the case-by-case considerations, meaning personal meetings between producers and the Prime Minister, government interference in the economy in favor of certain regions, sectors, or even specific enterprises (tax loopholes or free economic (actually, offshore) zones). The government will rely on the policy of the external borrowing from the international financial organizations and sales of attractive enterprises undergoing privatization to the Russian investors. The ruling circles will support the idea of further expansion of the Russian capital into Ukraine and the creation of the Russian-Ukrainian industrial-financial groups.

However, the external financing will be wasted without any visible improvement in the economy. Instead, the burden of external debt servicing will re-appear again and a threat of default will become imminent. The authorities will fall into the budget deficit trap once again although it is expected not to be very dramatic (3-5 percent of GDP).

Some cosmetic administrative reforms under external pressure could be expected. However, it would not prevent ruling circles from their "correction" and the return to the traditional Ministries or increased bureaucracy under the new names.

The pressure for devaluation of the hryvnia will not be so strong but 10-15 percent annual depreciation looks plausible. The investment crisis will further deepen. A number of new investment projects will be stalled.

The budget will continue to suffer losses from gas and oil traders, who remain reluctant to paying taxes for the transit of natural gas through the Ukrainian territory.

The government, headed by representatives of basic sectors, will conduct an industrial policy, which means the government monopoly and absence of a competitive environment in favor of energy-inefficient sectors (ferrous metallurgy, coal sector, fuels and electricity) and some favored engineering plants. However, the new market-oriented sectors will somewhat strengthen their positions due to better management and attraction of the more qualified Western-trained specialists.

Due to slow implementation of the reforms in agriculture this sector will remain highly vulnerable to external shocks although from time to time it will demonstrate some positive results.

Imports of natural gas from the CIS due to the moderate implementation of energy-saving technologies will go down to 45-50 billion cu. m. The share of monetary payments for the transit of the Russian gas through the Ukrainian territory will stabilize at the level of 30-35 percent.

The foreign reserves of the National Bank of Ukraine will reach the level of six-week imports.

The growth will be on average pretty slow (2-3 percent annually) and highly volatile.

Subsection 6.3: Optimistic scenario: revealing the long-term competitive advantages

In the optimistic scenario the following major conditions are expected to prevail:

- Quick changes in elite selection, arrival of market-oriented professionals;
- tough restrictions on and elimination of the major rent sources,
- policy with the emphasis on the right market incentives and actors' selection (fiscal, monetary, institutional policies), as well as social safety net development;
- development of the sophisticated labor-intensive sectors;
- rapid growth of small high-tech companies and subsidiaries of the multinationals with increase of exports of intellectual services and products;

- fast expansion of the financial sector.

According to this scenario, the pro-market forces will win elections in the spring 2002 and forthcoming Presidential elections in 2004. They will initiate and expand the policy of structural changes in the economy by, first of all, attacking the remnants of the non-monetary means of payments. The increase in money supply will exceed the rate of GDP growth, but not significantly, at 10-15 percent. It will manifest itself in a rising money demand, further monetization of the economy and strengthening of the national currency, which will:

- neutralize inflationary expectations,
- send signals for structural transformations,
- lower income and real exchange rate volatility,
- help to remonetize the economy,
- stimulate the balanced economic policy, and
- weaken the "special" relationships in the Ukrainian economy.

The policy of enhancement of the fiscal discipline will lead to a further increase of the budget revenues, successful fulfillment of the government obligations (first and foremost, elimination of wage, pension and other arrears), and, consequently, some improvement of the living standards of population. At the same time, it will restrict rent seeking.

The number of Western-educated and market-trained Ukrainians returning back to Ukraine will steadily grow, which will significantly improve the quality of management (including the governmental one), products and services. Foreign companies will come to Ukraine to employ the human capital in high tech and IT; hence increasing exports of high-skilled services. The Ukrainian modern manufacturing will undergo deep restructuring and, augmented with better management, will become internationally competitive.

The government will keep the positive balance of the current account. This policy is attractive due to a number of factors:

- Inexpediency of increase of the external debt;
- Non-inflationary stimulation of the purchasing parity power of population;
- Strengthening of expectations of price and monetary stability;
- Stimulation of a technology transfer;
- Specialization based on comparative advantages.

The government will clearly declare the Euro-Atlantic priority in the foreign policy, which would be supported by the OECD investors. The dismissal of

corrupted officials and elimination of the “compromising” structures will improve the playing field for economic actors.

Support of the positive balance of the current account does not mean the artificial restrictions on imports. On the contrary, exports will be considered as one of the main driving force of economic growth and its development will have domestic roots such as a need in technological modernization, improvement of marketing on the external markets, and structural changes. The export taxes will be minimized and the low unified import duty will be set up for all imported goods without any exceptions. Ukraine will join the WTO, CEFTA and some other regional trade agreements in 2003-2004.

After the further price liberalization and cancellation of subsidies on rent and utilities, transition to floating prices on the major goods, namely, natural gas, oil, wheat, etc., the authorities will conduct a policy of curbing inflation down to an average Central European 4-6 percent per year.

The government will continue the policy of reduction and restructuring of the external debt. The need in external borrowing will disappear. The sustainable maintaining of the positive budget balance is necessary for lowering of the banking rates and the spread between the lending and deposit rates. In this case the banking lending rates in hryvnias will fall to the “normal transitional” 15-20 percent and the spread will not exceed 8-9 percent. Another precondition for that – strengthening of property rights – will also take place due to the government’s abstinence from discretionary policy.

The pro-market leadership will spur further privatization of enterprises. The number of privatized enterprises will rise to 100 000 by 2005 from the current 82 000 ones in the middle of 2002.

The government will diversify energy supplies focusing on domestic production of oil and gas as well as imports of gas from the Western Europe (the Netherlands and Norway) and oil from Azerbaijan, Kazakhstan, and Middle East. At the same time the energy-saving technologies and meter systems will be implemented, which would help to reduce the overall consumption of energy by 20 percent. The structural changes in favor of low energy-intensive industries will reduce this consumption further.

Imports of natural gas from the CIS due to faster implementation of energy-saving technologies will fall to 35-40 billion cu. m. The share of monetary payments for transit of the Russian gas through the Ukrainian territory will go up to the level of 60-65 percent and even higher.

The system of private land ownership will be implemented and agriculture will start to grow quite rapidly at a 10-15 percent rate per year.

The foreign reserves of the National Bank of Ukraine will exceed the level of three-month imports.

In our opinion, after removing the main institutional barriers, Ukraine can achieve two-digit rates of growth.

Section 7:

Concluding remarks

We have examined Ukraine's transition for the last decade. What are the main lessons to be drawn from our analysis?

First, the role of selection of the economy actors, both managers and policy makers, is really crucial. Government officials and their privileged business partners, once being incorporated into the "elite" under certain institutional arrangement, become the carriers of this, often destructive for a society as a whole, arrangement through time. The way they adjust to the new conditions is heavily path dependent. In fact, the new elite was very successful in supporting the old institutional arrangements as soon as possible institutional changes could be potentially subversive for its rent seeking habits. The Ukrainian elite of the Soviet era was formed under the tradition of overconfidence in the inexhaustible resources that allowed Soviet leaders to delay reforms for decades. Being equipped with the old-minded and rent seeking leaders, the Ukrainian government of 1990s has discovered a "soft" external borrowing as a substitute for the "macro" rent it has been addicted to before. It has used the flows of funds from the T-bills market and external borrowing as a substitute for reforms. This is the way the D. North's "path dependence" has worked in Ukraine.

There is also a microeconomic mechanism behind the reluctance to reforms. In the case of Ukraine the micro rent seeking plays the crucial role in the preservation of the resource-oriented policy and creation of the virtual macro rents. As soon as the government remains resource-oriented, it propagates the rent seeking culture. The availability of macro rents strengthens the nomenklatura's "grabbing hand" and results in the highly unfavorable conditions, especially for the new businesses. Consequently, instead of the "creative destruction" Ukraine ended up with "implicit destruction", manifested in the high hidden unemployment, brain drain, wage and pension arrears, etc. The paternalistic attitude of the public allows the ruling circles to play a dirty game of extracting rents.

The second lesson is that due to historical reasons, institutional problems are deeply rooted. There is no way to change mentality of decision makers overnight, although there is a way to alleviate its economic consequences, which is to arrange the market-driven selection of less paternalistic personalities. But to do this, the government and the public should agree

on the non-paternalistic environment for the business and politics. Is there any escape from this vicious circle?

The third lesson is that the elimination of the external sources of macro rent, and the external hard budget constraints, can help. Just like the exhaustion of a macro rent has pushed ex-USSR to reforms in the mid-1980s, the end of the "virtual" macro rent has pushed Ukraine to reforms in 1998-2001. The positive experience of 2000 has demonstrated that the major restrictions for Ukraine's economic development are of the institutional nature, indeed. With less resources but harder budget constraints after the attack on non-monetary payments the economy started to show signs of revival.

Privatization facilitated although a slow, but steady transition of Ukraine's economy to the market tracks. It contributed to an increase of industrial output, with the highest rates of growth being achieved in the most privatized sectors of industry. Dissolution of the former collective farms led to positive results in agriculture. Despite all bureaucratic obstacles from the most conservative forces the institutional factor of reforming property relations became the leading driving force for taking economy out of the crisis.

Another potential factor of growth is fast assimilation of knowledge and skills, as well as availability of a start-up capital earned by millions of Ukrainians working abroad. Along with some simplification of taxation for small businesses (that was achieved under a public pressure) it has led to the expansion of the least paternalistic sector of small start-ups.

The fourth lesson is that understanding of Ukrainian transition experience should not be attempted relying on the purely economic reasoning. The problems experienced by Ukraine certainly have a very strong political flavor. The fact that the most reform-oriented government over the 1990s was promptly dismissed by the Parliament serves as a good confirmation of that. Unfortunately, Ukrainian elite is still weak and highly paternalistic, and this feature has strong historical roots. Here the "path dependence" is again in force.

Nevertheless, a number of factors allow us to state that the political economy situation in Ukraine is probably better than that in Russia. We foretell that a long-term trend will favor Ukraine since she has less profound sources of rents that are expected to be exhausted earlier. The short- and medium-term developments, however, depend heavily on the upcoming shifts in the economic and political elite. If the positive changes come soon, before the human capital substantially deteriorates, and if they are radical enough, Ukraine has a good chance to achieve two-digit rates of growth.